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BANK MANAGEMENT

A Case Book

BY

J. FRANKLIN EBERSOLE

PROFESSOR OF FINANCE
GRADUATE SCHOOL OF BUSINESS ADMINISTRATION
GEORGE F. BAKER FOUNDATION
HARVARD UNIVERSITY

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PREFACE

The object of this book is to provide present and prospective bank managers and public supervisors with realistic situations presenting the major problems of policy which must be properly solved for successful bank administration and public regulation. With few exceptions, the cases are taken from actual banking experience. Names have been changed and occasionally data slightly altered to prevent identification, except in the cases of Boston [Five Cent] Savings Bank, Corn Exchange Bank Trust Company, The First National Bank of Miami, The Peoples State Bank, The Farmers and Merchants National Bank, Fort Dearborn Banks, Bank of United States, Federal Reserve Bank of Minneapolis, Rhode Island Hospital Trust Company, and in the legal cases.

Bankers will find the problem of determining adequate liquidity clarified by the opening cases. Thereafter, the making of sound loans and the adoption of a sensible investment policy receive lengthy treatment. The crux of efficient bank operation, whether publicly or privately managed, is the making of proper loans and investments. The reader must be cautioned not to acquire a static view or formalistic habit in using balance sheet analysis for judging credits. The emphasis in bank credit and portfolio management must be placed on such dynamic factors as management intangibles, prospective income, and the effects of probable public policy. Appropriate consideration is given to the creative thinking required for expansion and development, to the problems of general administrative control and management, and to the relations of banks with public supervisory authorities, including the problems which have arisen with the emergence of positive money management.

Teachers will find that every consideration has been given to the needs of their students in the use of the case method. The sequence of cases within each section has been arranged to facilitate assimilation by the novice. The first case in each section contains references, winnowed by many years of critical reading and selected for the specific contribution to the respective

section topics. Most of the cases include searching questions designed to direct attention to the pertinent issues, and to stimulate their discussion in an orderly manner. By design, some cases have no questions attached so that the student reader may develop independently an ability to determine the critical issues involved. A few cases (such as Laurence National Bank and United Bank of America) were constructed in skeleton form primarily to meet the needs of teachers for thesis writing assignments. The appendices contain an exceptional collection of long series of data required to establish the money market and business conditions background by months for the years since 1920. To interpret dated cases, these appendices should be freely used. Students should graph the data wherever applicable.

The case method has the merit of affording a variety of treatment as illustrated in Appendix VI. Students and bank staffs either may review critically past decisions or may use the past only as a foundation or point of departure for creating a new policy to be executed in the future. In presenting the cases in this volume, no representation is made to the reader that the statements, conclusions, or policies found in these cases are either authoritative or sound. Management must be trained to distinguish between truth and falsity on the printed page and to discriminate between what is wise and unwise in selecting or approving a particular policy for action.

No book represents the unaided work of a single individual. The debt is great to those who have contributed practical experience, who have stimulated thought, and who have released information for publication. For field work in preparing the various editions (first edition, 1931; second edition, 1935; second edition, second impression, 1938) and for cheerfulness in receiving and offering suggestions for improvement, I am particularly indebted to John W. Harriman, Benjamin H. Larrabee, Pearson Hunt, and Robert W. Merry. In the preparation of copy and in the handling of proofs for the third edition, Miss Barbara E. Johnstone, Miss Frances V. Scott, Miss Grace M. Blanchard, and Mrs. Ebersole rendered valuable assistance.

J. FRANKLIN EBERSOLE.

BOSTON, MASS.,
August, 1940.

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I

LIQUIDITY

1. DETERMINATION OF THE AMOUNT OF BANK ASSETS NEEDED TO BE HELD AT DIFFERENT TIMES IN THE FORM OF CASH

BOSTON SAVINGS BANK

PROVISION OF CASH OR LIQUIDITY FOR MAXIMA RUNS[1]

In 1931, the Boston Five Cents Savings Bank experienced a "run" and therefore was confronted with the problem of providing cash for withdrawals to an extraordinary extent. The provision made in advance by the bank for such a situation and the developments during the critical days of the run were described in a public address by one of the officers.

Wilmot R. Evans, president of the Boston Five Cents Savings Bank, in addressing the convention of the National Association of Mutual Savings Banks here to-day . . .

. . . said that more than two years ago the bank made a study of runs on the institution, and the result indicated they could expect a run of major importance at least every fifteen or eighteen years. The tabulation indicated the maximum run would extend ordinarily not longer than a business week and, except in extraordinary cases, not more than 3 or 4 per cent of total deposits would be paid out during the period.

"In 1929 the industrial and commercial conditions were so alarming that a run was to be expected," Mr. Evans said. "It was essential, therefore, that we adopt a system of investment to the end that when the run came the demands of all depositors could be readily met. In order to do this we proceeded on a basis of a five times factor of safety. Therefore, if the ordinary run should result in the withdrawal of 3 to 4 per cent of our deposits not less than 15 per cent of our assets should be so invested in that type of securities which could most speedily be reduced to cash.

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[1] References for use with these cases on liquidity: Dunbar, C. F., *The Theory and History of Banking*, fifth edition, Chs. III and VI; Thorp, Willard L., editor, *Economic Problems in a Changing World*, Chs. XXV–XXVII, by F. C. James; Mitchell, W. F., *The Uses of Bank Funds*, Chs. I–II, IV–V; Rodkey, R. G., *Legal Reserves in American Banking*, Michigan Business Studies, Vol. VI, No. 5, especially Chs. 8 and 9; Berle and Pederson, *Liquid Claims and National Wealth*, especially Appendix B; Jamison, C. L., *Management of Unit Banks*, Michigan Business Studies, Vol. III, No. 2, pp. 217–240; *Federal Reserve Bulletin*, March, 1939, pp. 178–183; April, 1939, pp. 265–270; June, 1939, pp. 468–476; American Bankers Association, *Commercial Bank Management Booklet No. 11, Investment Policies of Banks*, pp. 3–11.

"On Dec. 14, 1931, a run of major importance started. At this time the funds of the bank were invested substantially as follows: About 17 per cent in Government bonds; about 11 per cent in Massachusetts municipal securities and State bonds; more than 3 per cent in the highest grade telephone bonds . . . ; about 2 per cent was cash on hand; more than 5 per cent was invested in high-grade public utilities.

"None of our bonds were rated by Moody at less than AA. The foregoing accounted for about 38 per cent of the deposits of the bank."

Mr. Evans said that on Monday, Dec. 14, the bank's business was normal, and on Tuesday, Dec. 15, when the Federal National Bank closed, their drafts increased. But on Dec. 16, a run of major proportions was evident.

"For a period of five days we had extremely heavy drafts. At the end of that time payments declined rapidly and the run speedily came to an end. During the week payments amounted to more than $5,177,000. Deposits were up to the average and exceeded $1,462,000. During the run we maintained large cash balances. In order to obtain sufficient funds for prompt payment we sold $5,200,000 United States Government bonds. At the time the run started we had $17,000,000 of Government bonds and, throughout, had ample reserves."

Mr. Evans said the bank's deposits on May 14 were $106,719,466, whereas on Dec. 23, when the run ended, deposits were $99,731,-243 . . . [1]

How much cash does a bank need?

How should "need" be defined? Is it based on meeting the ordinary daily withdrawals of depositors, on meeting the legally enforceable demands of depositors, on having sufficient funds available to meet legitimate and acceptable requests for loans, or on observing reserve requirements imposed by statute? May need be greater or less than legal requirements? Might a bank's action have any effect on its need in the future, or is its need a completely independent factor?

When a run occurs, do the depositors fundamentally want cash? What are the causes of runs? Can runs be foreseen? What policies or actions can and should be taken to stop runs before they reach dangerous proportions?

Has the establishment of the Federal Deposit Insurance Corporation affected the likelihood of a bank having a run? Would you expect the size or the time of occurrence of a run now to be the same as before?

---

[1] *Boston Transcript*, May 20, 1932, p. 15. For an interesting description of bank runs, written by George A. Kyle, Treasurer of the Boston Five Cents Savings Bank, see *Bulletin*, Harvard Business School Alumni Association, February, 1933, pp. 54–60. A more elaborate study is available for inspection at the bank.

Has any one bank ever held more or less cash than "need"? What are the consequences when a bank holds more and when it holds less cash than "need"?

For what reasons may a bank deliberately hold more cash than "need"?

What is a reasonable "margin of safety" in making provision upon the basis of past experience for future runs?

Should a bank hold at all times enough cash to meet a major run? How much "liquidity" in addition to "cash" does a bank need?

When a bank has ascertained the amount of cash that will probably be withdrawn in future periods, has determined a reasonable margin of safety to cover possible errors of calculation or forecast, and has made proper provision in the form of cash or its equivalent to cover these calculated amounts, should it not view the amount of the remaining assets as a permanent fund available for investment in any form that may reasonably be expected to produce the maximum net income in the long run?

NEBRASKA TRUST COMPANY

DISCOVERY AND MEASUREMENT OF REGULARLY RECURRING FLUCTUATIONS IN DEPOSITS[1]

The officer responsible for the daily decisions regarding the reserves of the Nebraska Trust Company of Omaha noticed that he had to provide more cash around the first of some of the months than at other times. He thought that investigation might reveal some regular variation occurring from month to month. He decided to ask a member of the bank's staff, Mr. Smith, who had completed some university courses in statistics, to make a study of this phase of the bank's operations.

Having secured Wednesday figures for deposits from the beginning of 1936 to January 17, 1940, the date of his study, Mr. Smith calculated weekly plus and minus changes as approximate indicators of the cash movements. He observed that there was no noticeable seasonal during the year but that there was a marked recurrent cash flow within each month. Roughly, cash flowed out during the first week and flowed in during the second week. In the latter half of the month, no uniform flow appeared, cash sometimes coming in and sometimes going out.

Since the first Wednesday in the month might fall anywhere from the first to the seventh, Mr. Smith did not believe that an analysis dividing the month into its first, second, third, and fourth weeks and a final fractional week would be satisfactory. Hence, in order to form a judgment from his data as to the movements during the month, he grouped together changes which had occurred during all the weeks ending on each day of the month. A "week," as he used the term, ran from Thursday through the following Wednesday. Thus, he found that on eight occasions the weeks ended on the first of the month, on seven they ended on the second, and so on through the month. The results of these calculations are presented in Exhibit 1.

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[1] The facts presented in this case coincide with those shown in the combined statement of the banks in the Kansas City district as reported to the Federal Reserve Board each week. The range of variation would probably be greater for some other one of the Kansas City district banks.

EXHIBIT 1

Nebraska Trust Company, Weekly Changes in Deposits from January 1, 1936, to January 17, 1940, Arranged by the Day of the Month on Which the Final Day of the Week Fell
(In tens of thousands of dollars)

	Day of the Month	Cash Flow during Weeks Ending on Each Day of the Month								
Group I	1	−3	−5	−6	−7	−1	−15	−9	−5	....
	2	−13	−17	−12	−6	−17	−10	−6	...	....
	3	−28	−5	−11	−4	−12	−17	−8	...	....
	4	−13	−16	−10	−12	−13	−6	....	...	....
	5	−28	+3	−8	−11	−13	0	−13	...	....
	6	−7	−11	−2	−10	+1	−5	−10	...	....
	7	0	0	−4	−1	+1	+1	....	...	....
	8	−15	−6	+7	−3	+8	−6	−2	−5	−11
Group II	9	+5	+10	+14	+10	+5	+3	+5	..	....
	10	+27	+3	+15	+7	+19	+7	+7	+9	....
	11	+19	+9	+11	+16	+25	...	....	...	....
	12	+26	+3	+15	+21	+18	+18	+19	...	....
	13	+26	+23	+22	+19	+12	+21	+10	...	....
	14	+10	+13	+20	+13	+16	+2	....	...	....
	15	+15	+4	+7	+13	+13	+18	+18	+4	+13
Group III	16	+14	−1	+11	+10	+8	+3	+3	...	....
	17	+8	+7	+3	+6	−2	+14	+4	...	....
	18	+5	−6	+4	+5	+2	−6	....	...	....
Group IV	19	−5	+3	−5	−5	0	−4	+2	...	....
	20	−14	−12	−8	−8	+2	−10	−5	...	....
	21	+2	−3	+1	−4	−8	−1	...	...	....
	22	−4	−4	−11	−7	−6	−1	−5	+8	−6
	23	−5	−5	−5	0	+2	+5	−3	...	....
	24	−8	−13	+1	+13	−3	+7	....	...	....
	25	0	+5	−2	−2	+2	+4	....	...	....
	26	−1	0	−4	−1	+2	+4	0	...	....
	27	−1	−4	+1	+9	−3	−8	−7	...	....
	28	−7	−2	−3	−13	+1	−1	....	...	....
	29	−3	−2	−3	+3	−3	−14	+1	+3	....
	30	+3	−12	−6	−8	−2	−5	....	...	....
	31	−8	−8	+1	....	....	....	....	...	....

Examination of the items so arranged showed that during the weeks ending on the first through the eighth the bank ordinarily lost cash. For the weeks ending on the ninth through the fifteenth, cash came in without exception. For the weeks ending on the sixteenth through the eighteenth, cash usually came into the bank, but in 4 of the 20 weeks a net loss was recorded. For the weeks ending on the nineteenth through the thirty-first, the major tendency was to lose cash, though for every date there was at least one occasion on which cash had increased. Upon the

basis of the foregoing inspection of the figures, Mr. Smith divided the month into four groups, as shown in Exhibit 1. Each week was classified according to the group within which the final day of the week, Wednesday, fell. Thus, a week beginning on Thursday, the twenty-eighth of one month, would fall into Group I.

After studying the data, the officer controlling reserves proposed to the executive committee that, at the beginning of each week, the bank should keep, in addition to the amount of its legal reserve requirements,[1] a cash sum equal to the worst week's drain indicated by the data for the particular group into which the week would fall, plus a margin of 10% of that drain for possible extreme variations which in the future might go beyond the limits of the statistics used. These amounts would then be: for each week in the first group, \$308,000; in the second group, none; in the third group, \$66,000; and in the fourth group, \$154,000. As a policy for administration he suggested that cash received during the weeks of the second group and excess cash received during the weeks of the other groups should be invested in noncustomer paper maturing at or just before the beginning of each week falling within the first, third, and fourth groups, and in the proportions of 308, 66, and 154, respectively, for each week in those groups.

Describe the actual or probable basic forces which determined the cash flows of the Nebraska Trust Company. Are these forces the same as those causing the cash flows described in the preceding case of Boston Savings Bank?

Should one expect to discover from a study of the daily closing balances in a particular demand deposit account any regularly recurring fluctuations? Should one expect to find the same fluctuations in time and in amount in each demand deposit account? Should one expect to discover from a study of the daily totals for all demand deposits in a given bank any regularly recurring fluctuations?

If regularly recurring fluctuations are discovered, and measured, should one expect to find them repeated in the future, both as to timing and amount?

---

[1] Legal requirements are discussed in the case of Country National Bank, *infra.*

COUNTRY NATIONAL BANK

COMPUTATION OF LEGAL RESERVE REQUIREMENTS[1]

On March 2, 1940, the assistant cashier of the Country National Bank was filling out the semimonthly "Statement of Demand and Time Deposits and Deductions" to be sent to the Federal Reserve Bank of Boston. In order to complete this form, it was necessary to compute the average daily net demand deposits, the average daily time deposits, and the reserves required to be held against each. The total of the reserves required was compared with the average reserve carried during the period at the Federal reserve bank as shown by the daily statements of account received therefrom.

The necessity for this action lay in the provisions of the Federal Reserve Act relating to legal reserve requirements and in Regulation D of the Board of Governors of the Federal Reserve System issued under the authority of the act. The pertinent sections of the statute are given in Exhibit 1, and selected portions of the regulation are reproduced in Exhibit 2. The reserves required were 5% of time deposits and 12% of net demand deposits, as of that date.[2] The Federal statute gave the Board of Governors the power to change within limits the percentage requirements. From time to time, they had been varied, as shown in Exhibit 3.

During the period ending on February 15, the bank had been deficient in its reserves kept with the Federal Reserve Bank of Boston, notwithstanding the method of averaging daily balances, and had been assessed a penalty therefor. The average deposit balances for the period as reported to the Federal reserve bank are given in Exhibit 4.

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[1] For a history of reserve requirements for banks in the United States, see *Federal Reserve Bulletin*, November, 1938, pp. 953–972. For some official discussion of changes in reserve requirements, see *Federal Reserve Bulletin*, August and September, 1936, pp. 613–617, 681; and May, 1938, pp. 343–344.

[2] The percentages applicable to any state member bank were the same as for a country national bank. For a compilation of reserve requirements of state banks, see "Provisions of State Laws Relating to Bank Reserves," *Federal Reserve Bulletin*, March, 1937, pp. 188–219.

EXHIBIT 1

Statutory Provisions of the Federal Reserve Act Relating to Legal Reserve Requirements*

Section 19 of the Federal Reserve Act provides in part as follows:

The Board of Governors of the Federal Reserve System is authorized, for the purposes of this section, to define the terms "demand deposits," "gross demand deposits," "deposits payable on demand," "time deposits," "savings deposits," and "trust funds," to determine what shall be deemed to be a payment of interest, and to prescribe such rules and regulations as it may deem necessary to effectuate the purposes of this section and prevent evasions thereof: *Provided*, That, within the meaning of the provisions of this section regarding the reserves required of member banks, the term "time deposits" shall include "savings deposits."

Every bank, banking association, or trust company which is or which becomes a member of any Federal reserve bank shall establish and maintain reserve balances with its Federal reserve bank as follows:

(*a*) If not in a reserve or central reserve city, as now or hereafter defined, it shall hold and maintain with the Federal reserve bank of its district an actual net balance equal to not less than seven per centum of the aggregate amount of its demand deposits and three per centum of its time deposits.

(*b*) If in a reserve city, as now or hereafter defined, it shall hold and maintain with the Federal reserve bank of its district an actual net balance equal to not less than ten per centum of the aggregate amount of its demand deposits and three per centum of its time deposits: *Provided, however*, That if located in the outlying districts of a reserve city or in territory added to such a city by the extension of its corporate charter, it may, upon the affirmative vote of five members of the Board of Governors of the Federal Reserve System, hold and maintain the reserve balances specified in paragraph (*a*) hereof.

(*c*) If in a central reserve city, as now or hereafter defined, it shall hold and maintain with the Federal reserve bank of its district an actual net balance equal to not less than thirteen per centum of the aggregate amount of its demand deposits and three per centum of its time deposits: *Provided, however,* That if located in the outlying districts of a central reserve city or in territory added to such city by the extension of its corporate charter, it may, upon the affirmative vote of five members of the Board of Governors of the Federal Reserve System, hold and maintain the reserve balances specified in paragraphs (*a*) or (*b*) hereof.

Notwithstanding the other provisions of this section, the Board of Governors of the Federal Reserve System, upon the affirmative vote of not less than four of its members, in order to prevent injurious credit expansion or contraction, may by regulation change the requirements as to reserves to be maintained against demand or time deposits or both by member banks in reserve and central reserve cities or by member banks not in reserve or central reserve cities or by all member banks; but the amount of the reserves required to be maintained by any such member bank as a result of any such change shall not be less than the amount of the reserves required by law to be maintained by such bank on the date of enactment of the Banking Act of 1935 nor more than twice such amount.

. . . .

The required balance carried by a member bank with a Federal reserve bank may, under the regulations and subject to such penalties as may be prescribed by the Board of Governors of the Federal Reserve System, be checked against and withdrawn by such member bank for the purpose of meeting existing liabilities: *Provided, however,* That no bank shall at any time make new loans or shall pay any dividends unless and until the total balance required by law is fully restored.

EXHIBIT 1. (*Continued*)

In estimating the reserve balances required by this Act, member banks may deduct from the amount of their gross demand deposits the amounts of balances due from other banks (except Federal reserve banks and foreign banks) and cash items in process of collection payable immediately upon presentation in the United States, within the meaning of these terms as defined by the Board of Governors of the Federal Reserve System.

. . . .

Notwithstanding the provisions of the First Liberty Bond Act, as amended, the Second Liberty Bond Act, as amended, and the Third Liberty Bond Act, as amended, member banks shall be required to maintain the same reserves against deposits of public moneys by the United States as they are required by this section to maintain against other deposits.

Section 11 of the Federal Reserve Act provides in part as follows:

The Board of Governors of the Federal Reserve System shall be authorized and empowered: . . . (*c*) To suspend for a period not exceeding thirty days, and from time to time to renew such suspension for periods not exceeding fifteen days, any reserve requirements specified in this Act: *Provided,* That it shall establish a graduated tax upon the amounts by which the reserve requirements of this Act may be permitted to fall below the level hereinafter specified . . .

* *Federal Reserve Act, as amended . . . October 1, 1935,* Secs. 11 and 19.

EXHIBIT 2

Portions of Regulation D, and of a Supplement Thereto, of the Board of Governors of the Federal Reserve System*

Section 2. Computation of Reserves

(*a*) Amounts of reserves to be maintained.—Every member bank of the Federal Reserve System is required by law to maintain on deposit with the Federal reserve bank of its district an actual net balance equal to 5 per cent of its time deposits plus—

12 per cent of its net demand deposits if not in a reserve or central reserve city;

17½ per cent of its net demand deposits if in a reserve city, except that if located in an outlying district of a reserve city or in territory added to such city by the extension of the city's corporate limits such bank may, upon the affirmative vote of five members of the Board of Governors of the Federal Reserve System, be permitted to maintain 12 per cent reserves against its net demand deposits;

22¾ per cent of its net demand deposits if located in a central reserve city, except that if located in any outlying district of a central reserve city or in territory added to such city by the extension of the city's corporate limits, such bank may, upon the affirmative vote of five members of the Board of Governors of the Federal Reserve System, be permitted to maintain 12 per cent or 17½ per cent reserves against its net demand deposits.

Notwithstanding any other provision of this regulation, the actual net balance which each member bank is required to maintain on deposit with the Federal reserve bank of its district in accordance with the foregoing shall be changed by such percentage, within the limitations prescribed by law, as the Board of Governors of the Federal Reserve System shall prescribe from time to time pursuant to the sixth paragraph of section 19 of the Federal Reserve Act, as amended by the Banking Act of 1935, in order to prevent injurious credit expansion or contraction.

EXHIBIT 2. (*Continued*)

(*b*) Deductions allowed in computing reserves.—In determining the reserve balances required under the terms of this regulation, member banks may deduct from the amount of their gross demand deposits the amounts of balances subject to immediate withdrawal due from other banks and cash items in process of collection as defined in subsection (*g*) of section 1 of this regulation. Balances "due from other banks" do not include balances due from Federal reserve banks, balances (payable in dollars or otherwise) due from foreign banks or branches thereof wherever located, or balances due from foreign branches of domestic banks. The word "banks" in the term "due from other banks" refers to incorporated banks and does not include private banks or bankers.†

(*c*) Availability of cash items as reserve.—Cash items forwarded to a Federal reserve bank for collection and credit cannot be counted as part of the minimum reserve balance to be carried by a member bank with its Federal reserve bank until the expiration of such time as may be specified in the appropriate time schedule referred to in Regulation J. If a member bank draw against checks before such time, the draft will be charged against its reserve balance if such balance be sufficient in amount to pay it; but any resulting impairment of reserve balances will be subject to the penalties provided by law and by this regulation.

. . . .

Section 3. Deficiencies in Reserves

(*a*) Computation of deficiencies.

(1) Deficiencies in reserve balances of member banks in cities where Federal reserve banks or branches thereof are located and in such other reserve cities as the Board of Governors of the Federal Reserve System may designate from time to time shall be computed on the basis of average daily net deposit balances covering semiweekly periods. Deficiencies in reserve balances of member banks in all other reserve cities shall be computed on the basis of average daily net deposit balances covering weekly periods. Deficiencies in reserve balances of other member banks shall be computed on the basis of average daily net deposit balances covering semimonthly periods.‡

(2) In computing such deficiencies the required reserve balance of each member bank at the close of business each day shall be based upon its net deposit balances at the opening of business on the same day; and the semiweekly, weekly, and semimonthly periods referred to in paragraph (1) hereof shall end at the close of business on days to be fixed by the Federal reserve banks with the approval of the Board of Governors of the Federal Reserve System.

(*b*) Penalties.

(1) Penalties for such deficiencies will be assessed monthly on the basis of average daily deficiencies during each of the reserve computation periods ending in the preceding calendar month.

(2) Such penalties will be assessed at a rate of two per cent per annum above the Federal reserve bank rate applicable to discounts of ninety-day commercial paper for member banks, in effect on the first day of the calendar month in which the deficiencies occurred.

. . . .

Section 4. Loans and Dividends While Reserves Are Deficient

It is unlawful for any member bank the reserves of which are deficient to make any new loans or pay any dividends unless and until the total reserves required by law are fully restored, and the payment of penalties for deficiencies in reserves does not exempt member banks from this prohibition of law. As provided in section 3 of this regulation, penalties for deficiencies in reserves are computed on the basis of the average reserve balances for semiweekly,

EXHIBIT 2. (*Continued*)

weekly, or semimonthly periods; but this prohibition of law applies whenever the reserves are deficient for one day or more, regardless of whether or not the average reserve balances for the semiweekly, weekly, or semimonthly period are deficient.

* Effective April 16, 1938. For the complete text of Regulation D, see *Federal Reserve Bulletin*, December, 1935, pp. 834–838. For supplements thereto, see *Federal Reserve Bulletin*, August, 1936, p. 624; March, 1937, p. 186; and May, 1938, p. 353.

† A member bank exercising fiduciary powers may not include in balances "due from other banks" amounts of trust funds deposited with other banks and due to it as trustee or other fiduciary. If trust funds are deposited by the trust department of a member bank in its commercial or savings department and are then redeposited in another bank subject to immediate withdrawal they may be included by the member bank in balances "due from other banks," subject to the provisions of subsection (*b*) above.

‡ Deficiencies in reserve balances of member banks in outlying sections of central reserve and reserve cities which have been authorized by the Board of Governors of the Federal Reserve System, under the provisions of subsection (a) of section 2 of this regulation, to maintain seven per cent reserves against demand deposits, will also be computed on the basis of average daily net deposit balances covering semimonthly periods.

Exhibit 5 shows the computation of the reserve required, of the reserve actually carried, and of the penalty for deficiency. The member bank was required to show on its periodic report the required reserves and any penalty incurred. In calculating the average reserve balances carried at the Federal reserve bank, uncollected checks sent to the Federal reserve bank[1] were not included. A credit was made, however, for currency shipped by the Federal reserve bank to the Country National Bank. It was the policy of the Federal reserve banks to credit out-of-town banks for currency shipped, in order to put them on an equal basis with the Federal reserve city banks. The former had to reduce their balance at the Federal Reserve Bank of Boston a day before they needed the currency, because of the time necessary for mail to reach them, whereas banks in Boston could wait until the day the currency would be needed before withdrawing it. For purposes of calculating reserve balances against legal reserve requirements, therefore, out-of-town banks were not considered to have withdrawn currency until the time consumed in shipment—one day for all members of the Federal Reserve Bank of Boston—had elapsed. The Country National Bank had drawn in currency $5,000 on February 7, $1,000 on February 14, and $700 on February 15—a total of $6,700. By adding this amount for 1 day to the sum of the daily balances before dividing by the 15 days covered, the bank was given credit for the currency while it was in transit.

[1] For a discussion of uncollected checks, see Vest, G. B., "The Par Collection System of the Federal Reserve Banks," *Federal Reserve Bulletin*, February, 1940, pp. 89–96. For a case, see Ebersole, J. F., *Bank Management—A Case Book*, first and second editions, Core State Bank.

EXHIBIT 3

Member Bank Reserve Requirements*
(Per cent of deposits)

Classes of Deposits and Banks	June 21, 1917 to August 15, 1936	August 16, 1936 to Feb. 28, 1937	March 1, 1937 to April 30, 1937	May 1, 1937 to April 15, 1938	April 16, 1938, and after
On Net Demand Deposits:†					
Central Reserve City..	13	19½	22¾	26	22¾
Reserve City..........	10	15	17½	20	17½
Country..............	7	10½	12¼	14	12
On Time Deposits:					
All Member Banks....	3	4½	5¼	6	5

* Source: *Federal Reserve Bulletin,* March, 1940, p. 214.
† Gross demand deposits minus demand balances with domestic banks (except private banks and American branches of foreign banks) and cash items in process of collection.

EXHIBIT 4

Country National Bank, Statement of Demand and Time Deposits and Deductions, for the Period Closing February 15, 1940*

Date	(1) Gross Demand Deposits	(2) Balances Subject to Immediate Withdrawal Due from Other Banks	(3) Cash Items in Process of Collection	Net Demand Deposits: Column (1) Minus Columns (2) and (3)	Time Deposits
1	$ 220,209	$ 22,745	$ 335	$ 197,129	$ 355,580
2	219,901	16,947	335	202,619	355,873
3	216,710	18,677	335	197,698	355,830
4	219,614	20,566	335	198,713	355,956
5	219,614	20,566	335	198,713	355,956
6	218,919	23,008	293	195,618	355,918
7	214,999	14,526	550	199,923	356,044
8	218,823	20,537	580	197,706	356,338
9	215,240	12,530	336	202,374	356,464
10	207,055	14,018	198	192,839	356,201
11	203,903	9,243	198	194,462	358,110
12	203,903	9,243	198	194,462	358,110
13	203,903	9,243	198	194,462	358,110
14	201,407	16,003	185	185,219	360,340
15	206,006	20,164	185	185,657	360,284
Total	$3,190,206	$248,016	$4,596	$2,937,594	$5,355,114
Average	....	....	......	$ 195,840	$ 357,008

* Portions of this statement have been omitted.

Daily figures for the second period of February, 1940, are given in Exhibit 6 for gross demand deposits, balances subject to immediate withdrawal due from other banks, cash items in process of collection, and time deposits. There were no shipments of currency in this period. The actual average balance carried as computed from the daily statements of the Federal reserve bank was $42,592.

EXHIBIT 5

Country National Bank, Computation of Reserve Required, Reserve Carried, and Penalty for Deficiency

12% of Demand Deposits of $195,840	$ 23,501	
5% of Time Deposits of $357,008	17,850	
Daily Reserve Required		$41,351
Total of Daily Reserve Balances	$579,610	
Credit for Currency Shipped	6,700	
Adjusted Reserve Balances	$586,310	
Average Reserve Balances Carried		39,087
Average Daily Deficiency		$ 2,264
Penalty at 3% per Annum		$ 2.79

EXHIBIT 6

Country National Bank, Data Used in the Computation of Legal Reserve Requirements, for the Period Closing February 29, 1940

Date	Gross Demand Deposits	Balances Subject to Immediate Withdrawal Due From Other Banks	Cash Items in Process of Collection	Time Deposits
16	$210,493	$21,589	$185	$360,918
17	200,451	10,508	185	360,992
18	193,110	12,021	185	361,051
19	193,110	12,021	185	361,051
20	193,624	12,600	185	361,219
21	204,419	17,581	195	361,525
22	211,997	13,159	20	360,950
23	211,997	13,159	20	360,950
24	213,779	24,060	10	362,768
25	211,767	28,256	10	363,074
26	211,767	28,256	10	363,074
27	212,369	23,778	10	363,173
28	209,130	26,649	310	362,802
29	214,514	26,941	310	365,521

May till money or correspondent balances be counted as reserves for meeting legal requirements?

Why should "cash items in process of collection" and "balances subject to immediate withdrawal due from other banks" be deducted from "gross demand deposits" in computing "net demand deposits"?

Why should there be a difference in the averaging period between central reserve city, reserve city, and country banks?

When a bank fails to maintain on any given day reserves equal to legal requirements, what follows? How does a bank know during the day whether or not its reserve is sufficient? What penalties or action result if a bank is continually short?

What are the maximum reserve requirements which the Board of Governors of the Federal Reserve System may set? What are the minimum requirements?

MILLS NATIONAL BANK

ANALYSIS OF CASH AND LIQUIDITY REQUIREMENTS FOR A COMMERCIAL BANK[1]

At a directors' meeting of the Mills National Bank, in June, 1929, the members of the board were discussing what changes in policy should be made as a result of the fact that the city of Albany, New York, in which the bank was located, would cease to be classed as a reserve city on July 1 of that year. The legal reserve requirements thereafter applicable would be those of a "country bank."[2] Consequently, a considerable reduction in cash[3] might legally be made.

Mr. Moore, a director, had thought and argued, for a year or more, that the bank had consistently maintained larger cash reserves than necessary, and that some of the funds so allocated should be "put to work." Since a majority of the directors had not agreed with him, he had abandoned his efforts in that direction, but the change of status of Albany afforded him an opportunity to reopen the question. His former statements were renewed and more of the directors were inclined to agree with him that the liquidity reserves had been too large.

Others vigorously opposed his position, stating that conservatism was the essence of good banking, and that to reduce the funds available to meet calls for cash might put the bank in an embarrassing position. In answer to this objection, Mr. Moore asserted that knowledge, not ignorance, was conservatism, and that since the bank had only an uncertain opinion of what its needs would be, it was not in fact conservatively managed. He proposed that a

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[1] The problem presented in this case, as in two preceding cases, Boston Savings Bank and Nebraska Trust Company, requires the use of statistical methods for solution, but the object in presenting these cases is neither to discuss statistical methods as such nor to exhaust the possibilities of statistical method. For example, a competent statistician might study in various ways the fluctuations in cash requirements in a given bank, in order that he might better understand the origins of these variations, and devise ways of predicting their occurrence. By the process of successively bringing into focus the originating causes of the fluctuations, the residue of unpredictable variations in the cash flow in most banks can be made smaller and smaller.

[2] For a study of "legal reserves," see case of Country National Bank, *supra*.

[3] The word "cash," as used in this case, comprehends till money and balances readily available at the Federal reserve and other banks.

study of the cash needs of the bank be made with a view to improving the management of the cash, and to test his own belief that the bank would find its reserves to be considerably in excess of its needs. After the matter had been debated at length, the directors became convinced that a study of the bank's cash needs would be valuable not only in showing whether they could reduce the funds then idle in reserves, but also in assuring them that sufficient funds would be on hand whenever needed.

A committee of directors was selected by the board to study the problem and report upon procedure. The committee recommended that the bank create a new position of "reserve officer," whose duties would consist of forecasting the probable future cash needs of the bank, of determining the size of fund sufficient but not excessive to meet the greatest of these needs, and of controlling such a fund held *solely* and *separately* for the purpose of meeting the cash needs. It was expected that, through the appointment of a special reserve officer, unnecessary holding of "unproductive" cash would be eliminated, first, by ascertaining how much, if any, of the fund could at any time be freed for temporary use and what restrictions on its investment were necessary in order to maintain the fund in condition to fulfill its purpose, and second, by freeing for permanent investment all other resources of the bank. To secure the highest possible net earnings in the long run upon the total fund to be set aside by the bank upon his recommendation, the directors believed the actual selection of securities in which any part of the sum might be invested could best be done by an investment officer. Hence the reserve officer was to be instructed to allocate to an investment officer any amount which could be invested and to specify how much of it would be needed on certain dates or on demand. The investment officer would then be held responsible not only for earning as much as he could with the money placed at his disposal under the restrictions given, but also for returning to the reserve officer at the stated times the specified amounts.

In considering the problem of reserves, the directors evolved a concept of the bank, new to them, in which the bank should plan its reserves to take care of its own customers but should have no obligation to noncustomers. Customers, they decided, were those depositors who relied on the bank for their borrowing needs, while noncustomers were those nondepositors who did not rely upon the bank for loans but borrowed in whatever place or way afforded the

lowest rates, such as by the issue of commercial paper or the borrowing of call money. In the case of customers, the bank assumed an attitude of responsibility for meeting their needs, but to noncustomers loans were made only upon the initiative of the bank by purchase in the open market and were collected at maturity with impersonal detachment. Each noncustomer loan was viewed as a separate transaction to be made or not at the will of the bank according to its current calculations of alternative opportunities for a short-run profit in other transactions. Adequate provision should be made for customers, therefore, not only so that the bank would never have to squeeze them, but also in order that it could be sure of supplying their customary and reasonable financial requirements. In addition to the existing customers of the bank, some consideration should be given, it was thought, to prospective customers in so far as their needs in the near future could be foreseen. To cover the costs of so managing itself as to be able to afford such assurance to its customers, the bank charged them more than the open-market rate on noncustomer paper.

The proposals of the committee were approved by the board, which then sought a suitable man to fill the position. After several months, Mr. Cummings, a young man who had been trained in statistics and who had a number of years' experience in banking, was employed. His authority and responsibility as reserve officer was scheduled to become effective on the first of December, 1929, although he began to study the problem somewhat earlier.

Mr. Cummings believed that the flow of cash into and out of the bank was not the result of any one factor but was a net change caused by a number of interacting influences. As an approach to determining the present cash needs of the bank, he decided to study the action of those factors or influences in the past, as they had changed the bank's need for cash. Three items seemed to him to control the movement of cash funds: time deposits, demand deposits, and loans to customers.

One would expect that decreases or increases in the amount of deposits would reflect cash drawn out or paid in, respectively. Clearly this was true of time deposits. Demand deposits, however, were not so simple in their action. By splitting them into those of borrowing and nonborrowing customers, Mr. Cummings thought confusion would be avoided. Demand deposits of nonborrowing customers were similar to time deposits in their action,

falling or rising only when cash was taken or received. The demand deposits of borrowing customers, on the other hand, did not necessarily fall within the same pattern. When a loan was made to a customer, the proceeds were *usually* made available in the form of a credit to the customer's deposit account. Hence, an immediate increase in such deposits resulted from granting loans. Conversely, repayment of a loan would reduce deposits. Consequently, if any change in deposits was caused by a loan transaction, no flow of cash funds was reflected by that change. In order to ascertain the changes in cash holdings by the use of the figures for demand deposits, therefore, any increase in loans had to be deducted from the deposit figure, and any decrease in loans had to be added thereto, before using the deposit figures as evidence of cash flows.

The loans made to customers were not credited in every case to deposit accounts. In a few instances the proceeds of the loans were taken immediately in the form of drafts upon correspondent banks or in currency. Similarly, a few of the loans were repaid with funds other than a check upon a deposit account in the lending bank. Under these circumstances cash would be withdrawn by each increase and restored with each decrease in such loans while deposits would remain unchanged by such transactions It was necessary, therefore, to deduct the amount of such loans when made, from the figure for deposits, and to add the amounts when repaid, to that figure, in order that the changes in the deposit figures, as adjusted, should reflect accurately the true cash flows. Since for loans made either by means of credits to deposits or by outlays of cash, the method of adjustment of the demand deposit figures was the same, Mr. Cummings believed it unnecessary to split customers' loans by the method of handling the proceeds.

Loans to *noncustomers* took cash in the same way as those to customers requiring the proceeds in drafts upon correspondents or in currency. Since the bank was under no obligation to make noncustomer loans, however, they did not form a part of the problem of determining the cash *needed* to operate the bank.

Each of the three items, time deposits, demand deposits, and loans to customers, was itself the net result of many counteracting forces within each of the individual accounts. If perfect knowledge of each customer's business were obtainable, Mr. Cummings thought reserve needs could be forecast with a high degree of

accuracy. As a practical matter, however, it would not be expedient to make separate studies of each of a large number of customer accounts where the individual effects on cash flows were slight. He planned to segregate any large and dynamic accounts for separate investigation. The remaining customers could then be grouped together and subjected to a statistical analysis.

Mr. Cummings asked for data, by weeks, for the last 15 years, of the amounts of time deposits, demand deposits of nonborrowers, demand deposits of borrowers, and loans to customers, in order that he might study the characteristics of these groups. The only records readily available turned out to be the quarterly statements of condition, 20 years of which were brought to him. These were of little help, for the loans to customers were not separated from the loans to noncustomers, and it was not possible to compute from such figures that part of the flow of cash which was attributable solely to the maintenance of customer-borrower relationships.

Personal inquiry among the officers of the bank revealed the existence of a record of certain pertinent items not shown in the general ledger. By the use of data taken from this record and from the general ledger, it was possible to construct a table which contained monthly figures for nearly four years on total demand deposits (not separated into borrowing and nonborrowing accounts), time deposits, loans to customers, cash, excess reserves, and secondary reserves.[1] Exhibit 1 reproduces the table. No other data relating to the cash needs had been assembled.

Mr. Cummings decided that although this information was inadequate for a definitive analysis of cash needs, a reasonably satisfactory study could be made from it for use in the immediate future. He planned to obtain more comprehensive figures, so that later he could refine any conclusions he might develop from the data at hand. In spite of not having the figures that he had expected and desired, he knew that the approach in this preliminary study would be essentially the same as in a comprehensive one. He believed that the advantage to be derived from such a logical analysis as he could make with the available figures would consti-

[1] The available data consisted of monthly averages of weekly figures as of the same day in the week. Mr. Cummings knew that such averages would not reflect the amplitude of cash flows within any one month or when comparing the averages for two successive months. However, he believed that such variations from the averages could be ignored in determining cash needs from day to day, because the bank would be able to utilize the cushion provided by the method of averaging permitted in calculating and maintaining the legal reserve requirements. *Cf.* Country National Bank, *supra.*

EXHIBIT I

Mills National Bank, Selected Statistics by Months, 1926 to 1929
(Monthly averages of weekly figures—In hundreds of thousands of dollars)

Date	Demand Deposits	Time Deposits	Loans to Customers	Cash	Excess Reserve*	Secondary Reserve
1926						
January	302	59	198	61	29	106
February	295	58	191	54	23	119
March	302	56	203	55	23	117
April	315	54	205	76	43	101
May	304	81	203	69	36	131
June	299	74	198	56	24	133
July	311	63	200	58	25	126
August	302	58	209	57	25	110
September	308	56	205	56	23	131
October	322	58	216	69	35	113
November	317	59	209	68	34	110
December	290	61	207	59	28	99
1927						
January	297	49	203	63	32	92
February	286	52	191	59	29	112
March	286	61	191	49	19	119
April	297	63	185	65	33	126
May	297	59	187	65	33	118
June	308	54	180	70	38	117
July	324	52	180	56	22	171
August	304	54	187	61	29	146
September	304	63	185	56	24	144
October	338	56	198	74	38	145
November	344	72	200	60	23	169
December	319	83	207	65	31	148
1928						
January	324	68	227	70	36	106
February	308	43	241	63	31	68
March	315	52	241	65	32	81
April	338	56	230	70	34	99
May	317	49	227	56	23	101
June	306	54	221	65	33	90
July	299	56	239	72	40	61
August	304	45	248	58	26	59
September	315	45	243	71	38	49
October	313	41	249	61	28	63
November	333	54	241	89	54	72
December	308	59	293	74	41	71
1929						
January	313	53	254	68	35	68
February	306	49	247	77	45	54
March	310	54	243	65	32	83
April	313	47	234	64	31	89
May	299	54	229	65	33	81
June	290	56	245	63	32	67
July	304	57	261	61	29	69
August	297	45	259	68	37	41
September	302	54	261	54	22	56
October	305	50	248	56	24	88
November	319	58	267	69	35	90
December	...	..	...	..	..	...

* Legally required reserves were 10 % of demand deposits and 3 % of time deposits. The excess reserves were calculated by subtracting the required reserves from the cash held. (This is not the same method as that used by the Federal reserve banks in calculating or estimating excess reserves.) On July 1, 1929, Albany ceased to be a reserve city, whereupon the legally required reserves were reduced to 7 % of demand deposits and 3 % of time deposits; the change was not recognized in computing the excess reserves thereafter, as presented in this table.

tute a greater improvement over the past management of reserves in this bank than would any subsequent study based upon additional data.

Before proceeding with a statistical analysis of the available data, Mr. Cummings conferred with the officers of the bank and drew upon their fund of experience, recollections, and current beliefs in order to ascertain which accounts were or had been both much larger and more active than the general run. These conferences revealed the existence of two customers with such large and active accounts. Both were investment trusts whose balances were large at one time and negligible at another. Fluctuations in their accounts are shown in Parts A and B of Exhibit 2. None of the other accounts was of sufficiently outstanding size to warrant individual attention.

EXHIBIT 2

Mills National Bank, Significant Changes in Segregated Large Accounts
(In hundreds of thousands of dollars)

Part A. Investment Trust "1"—In Bank at Start of Data	
Date	Change in Balance
June, 1927	+20
February, 1928	−20
August, 1928	+22
October, 1928	−22
August, 1929	+16
October, 1929	+13
Part B. Investment Trust "2"—Entered Bank, with Cash, in April, 1928	
Date	Change in Balance
April, 1928	+15
July, 1928	−15
November, 1928	+19
June, 1929	−19
Part C. Manufacturing Company	
Date	Change in Balance
Time Deposit	
May, 1926	+30
February, 1928	−30
Demand Deposit (Loan)	
December, 1928	−45
January, 1929	+45

Mr. Cummings also inquired whether any very large predictable, nonrecurring transactions had been experienced in recent years. There was one such instance—one of those occasions so unusual that everyone who had been in the bank at the time instantly remembered it. One of the customers, a manufacturing company with national distribution, had customarily carried large balances in banks scattered throughout the state. When, with little warning, it wished to withdraw these sums, it found that some of the banks were unable to pay on demand without great inconvenience, and that to insist would destroy the goodwill

sought by the original distribution of such balances. At least a month would be required for the depositary banks to liquidate assets in an adequate volume to furnish the cash. Because of this situation, the company had come to the Mills National Bank, asking for a loan of $7,500,000. Since this amount was much too great for the bank to handle alone, it arranged a syndicate in which it would advance $4,500,000 and two other banks would provide $1,500,000 each.[1] The loan was made in December, 1928, and was repaid in January, 1929. Although a substantial balance was being carried with the bank at the time Mr. Cummings was making his study, there had been no appreciable activity in the account since that incident. He did find, however, that in May, 1926, the company had made a deposit of $3,000,000 for which a certificate of deposit had been issued. The certificate was presented and paid in February, 1928. These changes in the account of the manufacturing company are shown in Part C of Exhibit 2. The effects of these irregularities in the deposit balances of the two investment trusts and of the manufacturing company could be removed from the data to be used as a basis for calculations.

Mr. Cummings decided to ascertain the net cash flow experience of the other depositors taken as a group and to act upon that evidence until more data could be found with which to study the characteristics of the individual factors. To determine the past cash flows, the activity in the pertinent categories had to be found and consolidated. After computing the monthly changes in demand deposits and in loans to customers and deriving therefrom the monthly gain or loss in cash from those sources, Mr. Cummings added thereto the cash gained or lost from changes in time deposits. The combined result revealed the net gain or loss of cash for the bank by months. These figures were then adjusted to eliminate the effects of those changes which he had already found in the large and active accounts. The results of these computations are given in Exhibit 3.

In a comprehensive study, it would be necessary to express cash movements as a percentage of some average deposit figure which would not reflect seasonal position, and to make allowances for trend and cyclical fluctuations. Mr. Cummings concluded that the value of such a detailed project with the monthly figures

[1] The borrower agreed to provide the Mills National Bank with such notes and security as would be necessary for that bank to meet the requirements of Section 5200 of the National Bank Act.

EXHIBIT 3

Mills National Bank, Computation of Cash Flows by Months, 1926 to 1929
(In hundreds of thousands of dollars)

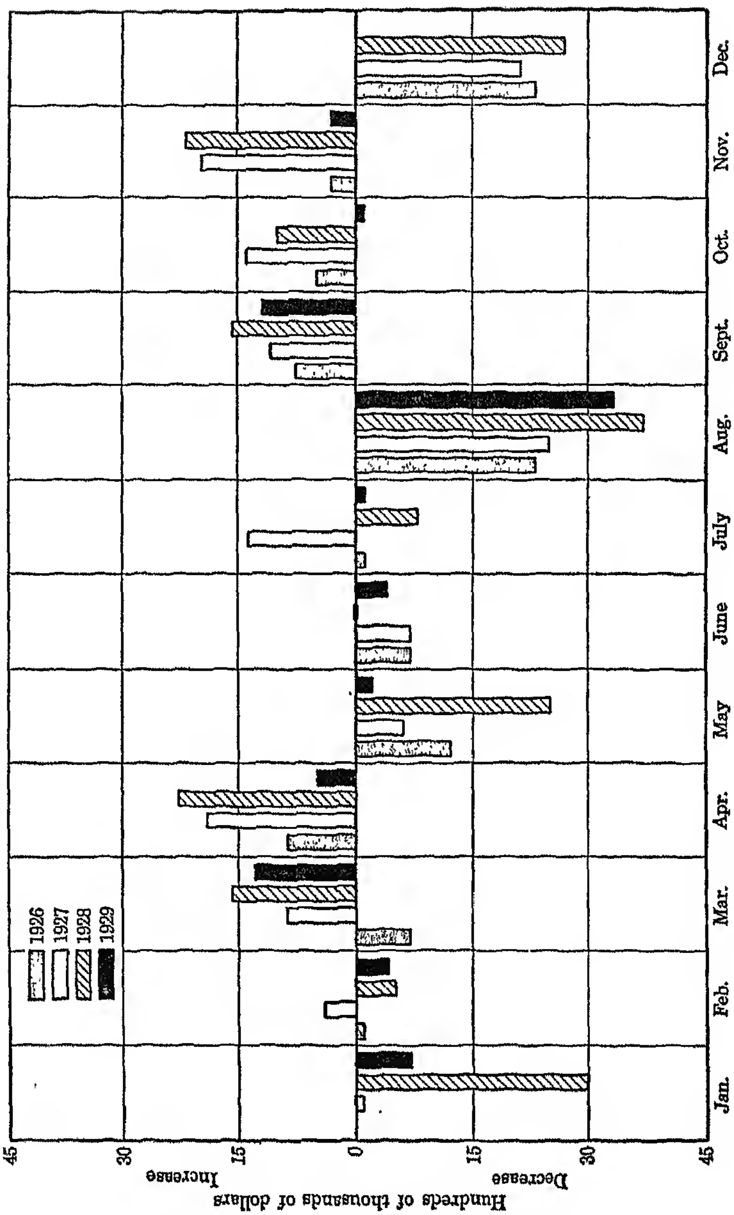
Date	Demand Deposits	Loans to Customers	Demand Deposits Adjusted for Loans to Customers	Time Deposits	Net Cash* Flows	Adjustments†	Adjusted Net Cash Flows
1926							
January							
February	−7	−7	0	−1	−1		−1
March	+7	+12	−5	−2	−7		−7
April	+13	+2	+11	−2	+9		+9
May	−11	−2	−9	+27	+18	−30	−12
June	−5	−5	0	−7	−7		−7
July	+12	+2	+10	−11	−1		−1
August	−9	+9	−18	−5	−23		−23
September	+6	−4	+10	−2	+8		+8
October	+14	+11	+3	+2	+5		+5
November	−5	−7	+2	+1	+3		+3
December	−27	−2	−25	+2	−23		−23
1927							
January	+7	−4	+11	−12	−1		−1
February	−11	−12	+1	+3	+4		+4
March	0	0	0	+9	+9		+9
April	+11	−6	+17	+2	+19		+19
May	0	+2	−2	−4	−6		−6
June	+11	−7	+18	−5	+13	−20	−7
July	+16	0	+16	−2	+14		+14
August	−20	+7	−27	+2	−25		−25
September	0	−2	+2	+9	+11		+11
October	+34	+13	+21	−7	+14		+14
November	+6	+2	+4	+16	+20		+20
December	−25	+7	−32	+11	−21		−21
1928							
January	+5	+20	−15	−15	−30		−30
February	−16	+14	−30	−25	−55	+50‡	−5
March	+7	0	+7	+9	+16		+16
April	+23	−11	+34	+4	+38	−15	+23
May	−21	−3	−18	−7	−25		−25
June	−11	−6	−5	+5	0		0
July	−7	+18	−25	+2	−23	+15	−8
August	+5	+9	−4	−11	−15	−22	−37
September	+11	−5	+16	0	+16		+16
October	−2	+6	−8	−4	−12	+22	+10
November	+20	−8	+28	+13	+41	−19	+22
December	−25	+52	−77	+5	−72	+45	−27
1929							
January	+5	−39	+44	−6	+38	−45	−7
February	−7	−7	0	−4	−4		−4
March	+4	−4	+8	+5	+13		+13
April	+3	−9	+12	−7	+5		+5
May	−14	−5	−9	+7	−2		−2
June	−9	+16	−25	+2	−23	+19	−4
July	+14	+16	−2	+1	−1		−1
August	−7	−2	−5	−12	−17	−16	−33
September	+5	+2	+3	+9	+12		+12
October	+3	−13	+16	−4	+12	−13	−1
November	+14	+19	−5	+8	+3		+3
December	....	....	....	....	....	....	....

* A short method of calculation would be to eubtract the figures for monthly loans to customers from the monthly total deposit figures and ascertain the monthly changes in the remainders.

† See Exhibit 2.

‡ Time deposits +30; demand deposits +20.

EXHIBIT 4
Mills National Bank, Adjusted Net Cash Flows by Months, 1926 to 1929



then available would not be worth the cost it would entail. As no marked trend seemed to be present either in the quarterly statements or in the monthly figures, and as a rise in loans to customers but not in deposits appeared to be the only cyclical manifestation plainly evident, he considered it safe to use actual rather than percentage figures.

To provide a convenient desk graph for daily reference, Mr. Cummings charted the monthly net cash flows as reflected by the changes in total deposits after adjustments for the effect of changes in customers' loans and for changes in the three large accounts which had been specially examined. The chart is shown in Exhibit 4.

From this chart he saw that there were many types of situations for which provision had to be made. The months were divided between those having seasonals and those not having seasonals. Of the former, some had seasonal inflows and some seasonal outflows; some had never had a flow in the opposite direction from the seasonal, while others had experienced such a perverse flow. He concluded, therefore, that the bank's need for cash fell into three classifications: (1) a normal need which was that most likely to occur regularly; (2) a further need to cover the difference between the normal need and the worst experience that had actually occurred, and which presumably would recur infrequently; and (3) a margin for possible future instances in which the need might exceed even the worst experience of the past.

The next step was to determine the normal need for each month in accordance with its own particular characteristics. By inspection, Mr. Cummings decided that February and July were the only months having no normal seasonal movement of cash. Since it was not possible, therefore, to estimate any flow that could usually be expected in February or July, he decided to consider the worst experience for those months as though it were the normal need. For the remaining months, all of which exhibited an apparent seasonal, he decided to consider the median as the normal cash flow to be expected. Where this normal flow took cash out, the amount of it was to be considered the normal need. Months having a normal inflow of cash could be and were ignored in this portion of his analysis. Figures for these and the following calculations are given in Exhibit 5.

Mr. Cummings believed that provision for the liquidity requirements should be related to the degree of need. He decided to have

EXHIBIT 5

Mills National Bank, Calculation of Monthly Needs

(In hundreds of thousands of dollars)

Month	Normal Cash Flow	Worst Cash Experience	Normal Need	Greatest Past Need	Spread from Normal Need to Greatest Past Need
January......	− 7	−30	7	30	23
February.....	?	− 5	5	5	0
March.......	+11	− 7	0	7	7
April.........	+14	+ 5	0	0	..
May.........	− 9	−25	9	25	16
June.........	− 6	− 7	6	7	1
July.........	?	− 8	8	8	0
August.......	−29	−37	29	37	8
September...	+11	+ 8	0	0	..
October......	+ 7	− 1	0	1	1
November....	+11	+ 3	0	0	..
December....	−23	−27	23	27	4

the normal need for each particular month in cash at the beginning of each month. Any difference between the normal need and the maximum need for each month would be kept in quickly salable, callable, or rediscountable assets.[1] The accounts of the two investment trusts and any large demands of which he had advance notice were to be covered entirely by cash, in addition to that otherwise kept. Thus, in fact, there were two reserves: one for the accounts studied individually and one for the rest. The two would be computed separately, then combined to give the total needs for each month. After inspection of the figures in Exhibit 5, Mr. Cummings set the margin of safety at $500,000, which he decided to hold in the form of cash rather than in secondary reserves.

Mr. Cummings felt that he had a satisfactory, although tentative, method for determining the monthly drains, which would be provided for by sufficient cash or assets readily convertible into cash. On the basis of his method, he decided to make a short forecast for the first 60 days. From the data in Exhibit 5 he concluded that $3,500,000 in cash and $2,700,000 in secondary reserves would be sufficient to meet the outflow. He planned to begin conversion of secondary reserve assets into cash whenever his cash fell below $500,000, thereby using his margin of safety as a first line of defense while effecting conversion. The sum to be in cash or on demand from the investment officer for the first 60 days

[1] The selection of such assets will be more adequately treated in a later case.

therefore amounted to $6,200,000, *in addition to the legal reserve requirements.*

Calculation of the size of reserve fund sufficient to cover the liquidity needs of the bank for the next year, yet which would include no funds not needed for that purpose, remained to be determined. The worst experience of any one month seemed insufficient, since two or more months at times suffered successive drains. Furthermore, it was necessary in calculating the largest cumulative amount of successive drains to recognize that a period of outflow might be interrupted but not terminated by an inflow which was insufficient to compensate for the drainage either preceding or following it.

He recognized that if he had more time, data, and experience, he would be able to decide whether the forthcoming year would be more like one of the preceding years than another, and that he could make use of the historical annual cash flows in setting the size of fund he wished to have on hand. Since this decision was to cover the first period of his responsibility on the job, however, he thought it would be wiser for him to compute his total fund on the basis of the worst cash drain that had occurred in any 12-month period of the past, adding thereto the margin for safety. The worst past drain he found to be $8,700,000, which, with the added $500,000 margin, gave a reserve fund of $9,200,000 to be kept, in addition to legal reserve requirements.

To help him in watching closely the position of the fund during the year, he planned to make up a schedule showing how much he thought would be needed in each category each month and what amounts would have to be invested or liquidated at the beginning or end of each month in order to provide the desired reserves. This schedule would be subject to constant adjustment as the facts became known.

As a result of his study, he concluded that the bank could release for permanent investment about $1,400,000. In addition, $3,000,000 of his reserve fund could be invested in 60-day maturities. At the end of that time he would have completed a much more thorough examination of the cash flows of the bank, and he thought it likely that an additional amount might be freed at that time.

Should Mr. Cummings have accepted the position of reserve officer when a majority of the board of directors were either

skeptical of or opposed to the study? After taking the job, should he have tried more actively to prove its importance to the directors?

Should Mr. Cummings have been given full responsibility for the fund at once? After six months? A year?

Why, when, and to what extent does a business draw from or deposit in a bank?

Are not depositors' needs the only real cash needs of a bank? Why should a bank consider provision of borrowing customers' needs equally important? Why did Mr. Cummings wish to study borrowing and nonborrowing customers separately? Was it necessary or desirable to distinguish between customers' and noncustomers' loans? Is a bank justified in collecting a higher rate on a loan to a customer than to a noncustomer?

Was the adjustment of the deposit figures for customer loans a significant improvement of the data used to determine cash flows or was it a fastidious refinement?

How much reliance should have been placed on the memories of the staff in looking for irregularities in accounts? Do random factors have any regularities of their own, different from the annual pattern Mr. Cummings looked for, which may permit them to become predictable?

Should nonpredictables be covered 100% by reserves? If unpredictables are so covered, could not a portion of the reserve held for them serve as a margin of safety for other drains, thereby releasing the margin Mr. Cummings decided to keep?

Should the arbitrary margin of safety be varied inversely with interest rates obtainable upon assets that qualify as secondary reserves?

If we rely upon shiftability at all in meeting cash requirements, why should any one bank be concerned to forecast its cash needs beyond "one day," assuming that one day is the time interval in which assets can be converted into cash in the bank?

Was the study based on the available data worth making? Would the more comprehensive study on data to be collected be worth making? How much would the profit or loss resulting from the employment of the statistician have been if his method had been applied to the years for which data were given?

Prepare a schedule of the dollar amounts of cash that would probably be needed during each of the 12 months following the data in this case. Prepare also a schedule of the secondary reserves which would be kept during those months, showing for

each month how much would be kept in immediately realizable assets and how much could be allocated for temporary investment. For the latter show when the funds would have to be returned to cash.

Can the basic cash flow of a bank be related to outside statistical series which may be used as barometers? If so, what series would be useful for purposes of forecasting cash needs? What effect does government money management have on such forecasts?

Prepare a chart containing a graph for each year beginning February 1 of the cumulative net basic cash flow as adjusted, 1926 to 1929. From a study of this chart and of any other available data on business conditions during the same period, determine so far as possible the probable reasons for the indicated differences of the cash flows in the several years.

Appraise the decision of Mr. Cummings to ignore problems of trend and of a business cycle. What clues are afforded by the data as to these problems?

Compare the method of analysis used in the Mills National Bank case with that prepared by The First National Bank of Boston ("An Approach to the Investment Problem of a Commercial Bank with Particular Regard to Liquidity," especially pages 9–14).

2. POLICIES AND METHODS FOR ASSURANCE OF ADEQUATE CASH WHEN NEEDED BY A BANK

CHICAGO NATIONAL BANK

PURCHASE OF MATURITIES VERSUS REDISCOUNTING AS A POLICY FOR PROVIDING CASH FOR PREDICTABLE NEEDS[1]

During the last days of November, 1938, the directors of the Chicago National Bank, a large commercial bank, were engaged in discussing the policy that should be followed to meet cash withdrawals during the ensuing six months.

The officers of the bank had been able to estimate with a high degree of accuracy the amount of funds that would be withdrawn during March because of the similarity in the characteristics of the drain from year to year and because of their familiarity with the large deposit accounts.[2] The experience of the previous March, given in Exhibit 1, was considered to be quite typical. At the time of the discussions there was no indication that the 1939 performance would be abnormal in any respect.

In the past it had been an important part of the bank's portfolio policy to make exact provision for the expected drain by acquiring beforehand, and selling as needed, April maturities of Treasury bills. An officer expressed the opinion that the bank should not purchase such maturities but should depend upon the Federal reserve bank for rediscount accommodation during this period and should arrange its portfolio without reference to the March drain. He believed that it would be more advantageous

[1] For the borrowing powers and practices of member banks at the Federal reserve banks, consult: Turner, R. C., *Member-Bank Borrowing;* Hardy, C. O., *Credit Policies of the Federal Reserve System;* Kemmerer, E. W., *The ABC of the Federal Reserve System*, eleventh edition; Spahr, W. E., *The Federal Reserve System and the Control of Credit;* Willis and Steiner, *Federal Reserve Banking Practice*. For broader questions regarding Federal reserve policy, numerous other references are presented in the Laurence National Bank case, *infra*. On the subject of state bank membership in the Federal Reserve System, consult case of Mosher State Bank, Ebersole, J. F., *op. cit.*, first edition, pp. 389–394; second edition, pp. 235–240.

[2] The state levied a tax on all personal property, including bank deposits, held on the 1st of April. In order to avoid this tax many individuals and corporations withdrew their funds during March and invested them in short-term tax-exempt securities. For a brief but satisfactory summary of this tax law, see *American Banker*, March 30, 1939, p. 3.

for the bank to utilize its resources in the most profitable manner, as determined only by long-run considerations.

One of the directors was definitely opposed to such a change in policy. He stated that a bank should endeavor to maintain an independent position of sufficient liquidity to meet all but the greatest of emergencies and should go into debt to the Federal reserve bank only when it was absolutely necessary to do so for an unpredictable drain. Moreover, he questioned the direct profitability of the proposed change in view of the current money rates,

EXHIBIT 1

Selected End-of-week Totals in Deposit Groups of the Chicago National Bank as Shown in Its Weekly Report to the Federal Reserve Bank*
(In thousands of dollars)

Date	Demand Deposits Adjusted	Time Deposits	United States Government Deposits	Deposits of Other Domestic Banks
1937				
December 1...	15,807	4,536	455	5,297
8...	15,862	4,545	454	5,236
15...	15,968	4,544	652	5,242
22...	15,589	4,557	657	5,309
29...	15,577	4,558	658	5,328
1938				
January 5...	15,176	4,659	659	5,575
12...	15,302	4,652	659	5,646
19...	15,161	4,651	634	5,667
26...	15,414	4,648	633	5,692
February 2...	15,218	4,696	622	5,621
9...	15,357	4,695	621	5,618
16...	15,266	4,697	621	5,763
23...	15,212	4,698	621	5,634
March 2...	14,924	4,698	928	5,869
9...	14,889	4,681	1,034	5,768
16...	14,594	4,684	1,164	5,790
23...	14,033	4,684	1,163	5,786
30...	12,105	4,664	1,167	6,147
April 6...	13,366	4,618	1,164	5,948
13...	14,077	4,632	1,169	5,974
20...	14,508	4,641	1,168	6,233
27...	14,929	4,643	1,161	6,438
May 4...	14,762	4,647	1,165	6,549
11...	15,043	4,646	1,168	6,536
18...	15,184	4,639	1,173	6,670

* For the purpose of simplifying the study of this case, it has been considered advisable to overlook the effect that fluctuations in loans and discounts might have on the cash position of this bank. See case of Mills National Bank, *supra*.

The reserves required of Chicago member banks on December 1, 1938, were 22¾ % of adjusted demand deposits and 5 % of time deposits. Adjusted demand deposits were gross demand deposits minus demand balances with domestic banks (except private banks and American branches of foreign banks) and cash items in process of collection. See case of Country National Bank, *supra*.

later published as shown in Exhibit 2, and the character of the bank's portfolio, as classified and given in Exhibit 3.

Would the problem or the proper solution be any different if the seasonal variation were due to other predictable causes?

When a bank knows that a regularly recurring cash drain of an amount substantially predictable will occur, is there any better method for meeting such a drain than to hold dependable maturities of the proper dates and amounts?

EXHIBIT 2

Money Rates, November 26, 1938*

Types	Per Cent Per Annum
In the Open Market	
Prime Commercial Paper, 4 to 6 Months	5/8 (prevailing)
Prime Bankers' Acceptances, 90 Days	7/16 (prevailing)
Call Loan Renewals	1 (average)
Treasury Bills, 91-day Dealers' Quotation	.04 (average)
Treasury Bills, New Issues Offered in Week	.02 (average)
Treasury Notes, 3 to 5 Years	.72 (average)
Treasury Bonds, 12 Years or More	2.51 (average)
Discount Rates at the Federal Reserve Bank of Chicago	
Rediscounts and Advances under Sections 13 and 13(a) of the Federal Reserve Act	1½
Advances under Section 10(b) of the Federal Reserve Act	2
Advances Secured by Direct Obligations of the United States	4
Federal Reserve Bank Buying Rates on Acceptances	
1–90 days	½
91–120 days	¾
121–180 days	1

* Source: *Federal Reserve Bulletin*, December, 1938, pp. 1069–1070.

In calculating the amount of funds that will become available on various dates, should a bank catalogue depend upon the amounts and maturities of customers' loans held?

Should any bank aim to provide from its own assets more cash than enough to meet easily predictable needs when the bank retains membership in a central banking system such as the Federal Reserve System?

Is the Federal Reserve System able and willing at all times to provide liquidity: (*a*) seasonally, (*b*) in particular emergencies confronting one or a few banks, and (*c*) when there is a general collapse of confidence?

Does a member bank of a Federal reserve bank have a legal right to demand rediscount or loan accommodation therefrom upon the presentation of loans or securities, the holdings of which were not disapproved by the "Federal" examiners when the bank was last examined?

If as a policy a bank holds less than enough cash to meet a major run, or even the greatest probable drain during a given year, should it rely upon its ability to forecast such a run and to provide the necessary cash beforehand, or upon its ability to convert its assets into cash as runs develop?

EXHIBIT 3

Weekly Report of the Chicago National Bank Sent to Federal Reserve Bank as of December 1, 1938
(000 omitted)

Assets	
Commercial, Agricultural, and Industrial Loans	$ 5,892
Open-Market Paper	688
Loans to Brokers and Dealers	801
Other Loans for Purchasing or Carrying Securities	1,169
Real Estate Loans	623
Other Loans	1,007
United States Government Bills	1,962
United States Government Notes	2,008
United States Government Bonds	3,451
Obligations Fully Guaranteed by United States Government	669
Other Securities	3,233
Reserve with Federal Reserve Bank	7,157
Cash in Vault	851
Balances with Domestic Banks	1,129
Cash Items in Process of Collection	1,051
Other Assets	529
Total	$32,220
Liabilities	
Demand Deposits	$17,272
Time Deposits	4,668
United States Government Deposits	623
Domestic Bank Deposits	6,817
Foreign Bank Deposits	91
Other Liabilities	169
Capital, Surplus, and Undivided Profits	2,580
Total	$32,220

In any plan to provide the necessary cash beforehand, or as runs or drains develop, should a bank aim to do so by: (*a*) purchasing (and collecting) unequal amounts of several *selected* maturities, (*b*) purchasing (and collecting) equal amounts of *serialized* maturities, (*c*) purchasing (and rediscounting) rediscountables, or (*d*) purchasing (and selling) salables?

What would be the relative profitability of the two courses of action suggested in this case?

Should the Chicago National Bank have adopted the proposed change?

TENTH NATIONAL BANK

PURCHASE OF BANKERS' ACCEPTANCES FOR SELECTED MATURITIES, REDISCOUNT, OR SALE[1]

On the morning of February 21, 1930, Mr. Consodine, an assistant cashier in the Tenth National Bank of New York, was requested by the president of the bank to purchase $300,000 of bankers' acceptances, selected according to his discretion. Mr. Consodine directed the operations of the foreign department, the negotiation of acceptance credits for customers, the sale of the bank's own acceptances, and the purchase of those of other banks and bankers. The face values of the acceptance holdings of the bank at that time were as follows: National City Bank of New York, $106,211; Union Trust Company of Cleveland, $81,769; First National Bank of Boston, $142,001; National Shawmut Bank, $91,670; Guaranty Trust Company, $128,412; Kidder Peabody Acceptance Corporation, $76,082. The maturities of these acceptances were distributed approximately evenly over the next four months. In addition, the bank held $287,511 of its own acceptances which were available for sale. All this paper was classified as "prime," and all, except one of its own acceptances for $9,616, was eligible for rediscount at the Federal reserve bank. This bill was a renewal draft and could not be classified as eligible because of a technicality in regard to the type of transaction involved. The Tenth National Bank expected to hold this acceptance until maturity.

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[1] References for use in preparing this case and subsequent cases on acceptances: Burgess, W. R., *The Reserve Banks and the Money Market*, revised edition, Ch. X; Willis and Steiner, *Federal Reserve Banking Practice*, Ch. XV; Warburg, P. M., *The Federal Reserve System: Its Origin and Growth*, Vol. II, pp. 181–223, 623–644, and 781–790; Leaf, Walter, *Banking*, pp. 92–94, and Chs. VII–VIII, for a description of the London market. For statistics and articles on contemporary conditions, see the *Acceptance Bulletin*, published monthly until June, 1936.

For the powers of the Federal reserve banks to discount and purchase bills, and of the member banks to accept drafts and bills, see: Regulation A of the Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, October, 1937, pp. 984–995; Regulations of the Federal Reserve Board, Regulations B and C, *Annual Report of the Federal Reserve Board*, 1930, pp. 237–239.

For a typical case of purchasing foreign acceptances, see Strawbridge National Bank, *infra*.

In order to carry out his instructions, Mr. Consodine telephoned a dealer in acceptances and asked for a list of offerings. This list is given in Exhibit 1. All the acceptances offered for sale were prime bills except those of two small banks, the Emerson National Bank and the Morton Trust Company, and of one private banking firm, Rawlins & Dunkle. All the bills, however, were considered eligible. Data regarding the acceptors are given in Exhibit 2. No information was on file concerning Rawlins & Dunkle, but the dealer informed Mr. Consodine that it was a small but well-established firm and that its credit rating was excellent.

EXHIBIT 1

List of Acceptance Offerings

Maturity	Amount*	Acceptor	Bid and Asked Price†
30 Days and Under	$ 18,742	Chase National Bank	3⅞–3¾
	35,138	Guaranty Trust Company	3⅞–3¾
	27,615	Kidder Peabody Acc. Corp.	3⅞–3¾
31 to 60 Days	52,883	Chase National Bank	3⅞–3¾
	11,109	Foreman-State National Bank	3⅞–3¾
	88,206	Guaranty Trust Company	3⅞–3¾
	31,876	Atlantic National Bank	3⅞–3¾
	38,890	Kidder Peabody Acc. Corp.	3⅞–3¾
	7,435	Emerson National Bank (Phila.)	4 –3⅞
61 to 90 Days	121,216	Chase National Bank	3⅞–3¾
	43,667	Foreman-State National Bank	3⅞–3¾
	92,921	Guaranty Trust Company	3⅞–3¾
	27,600	Atlantic National Bank	3⅞–3¾
	56,003	Kidder Peabody Acc. Corp.	3⅞–3¾
	31,210	Second National Bank (Boston)	3⅞–3¾
	18,406	Emerson National Bank	4 –3⅞
	26,282	Morton Trust Company (N. Y.)	4 –3⅞
	23,714	Rawlins & Dunkle (N. Y.)	4⅛–4
91 to 120 Days	44,330	Chase National Bank	3⅞–3¾
	102,546	Guaranty Trust Company	3⅞–3¾
	71,298	Atlantic National Bank	3⅞–3¾
	42,070	Kidder Peabody Acc. Corp	3⅞–3¾
	6,417	Second National Bank	3⅞–3¾
	14,228	Emerson National Bank	4 –3⅞
	27,930	Morton Trust Company	4 –3⅞
	32,690	Rawlins & Dunkle	4⅛–4
121 to 180 Days ...	38,667	Chase National Bank	4 –3⅞
	81,171	Guaranty Trust Company	4 –3⅞
	29,001	Kidder Peabody Acc. Corp.	4 –3⅞
	4,605	Morton Trust Company	4⅛–4

* Face value, cents omitted.
† The spread of ⅛ between the buying and selling price constitutes the dealer's commission.

Mr. Consodine had to make a decision in regard to the names, amounts, and maturities to be purchased. Open-market interest rates had shown a rapid decline in the preceding three months, and the lowering of the New York, Chicago, and Boston Federal reserve rediscount rates had been accompanied by a further decline in rates on call loans, commercial paper, and acceptances.[1]

The acceptance holdings of the Tenth National Bank constituted a part of the bank's secondary reserve so that, even though many of the acceptances were held to maturity, both marketability and yield were important considerations.[2] Whenever acceptances had been purchased and delivery made, Mr. Consodine was accustomed to have them pass over his desk. This inspection furnished valuable information concerning various business transactions, since the type of transaction which gave rise to the bill was stamped on its face. The previous purchase of acceptances which he had inspected had contained a large block arising from the import of hides. The bank had lost heavily on several customers' loans to companies in the tanning industry, and Mr. Consodine was uncertain as to the desirability of holding this paper in the bank's portfolio. He had no objection to any other industry except rubber manufacturing. Furthermore, in his opinion, a few of the drawers of acceptances already purchased were not of the highest credit rating. Exhibit 3 contains data on the volume of acceptances outstanding, classified according to their source.

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[1] For money rates, see Appendix III. For the money market outlook, see: Harvard Economic Society, *Weekly Letter* of February 1, 1930, or publications of other services appearing at the same time.

[2] Bankers' acceptances can be sold in the open market, sold outright or under repurchase agreements to the Federal reserve banks, rediscounted, or used as collateral for 15-day loans at such banks. The Federal reserve banks maintain buying rates for prime endorsed eligible bills. Higher rates may be exacted for other classes of bills. The endorsement must be satisfactory to the Federal reserve bank, and bills thus endorsed command a premium of 1/8 of 1% above the quoted rate on unendorsed bills of the same class. This form of endorsement must not be confused with the "without recourse" endorsements which bills receive in the process of collection. The buying rates on acceptances at the Federal Reserve Bank of New York are given in the *Federal Reserve Bulletin*, and on February 21, 1930, these rates were as follows:

1 to 15, 16 to 30, and 31 to 45 days	3¾%
46 to 60, 61 to 90, and 91 to 120 days	3⅞%
121 to 180 days	4¼%

These rates were established on February 11, 1930, the previous rates having been higher on all maturities.

EXHIBIT 2

Information in Regard to Acceptors

A. Statement Figures for Banks, as of December 31, 1929 (000 omitted)

Name	Capital	Surplus	Undivided Profits	Deposits	Acceptance Liability
Atlantic National	$ 8,000	$ 8,503*	....	$ 114,111	$ 9,319
Chase National	105,000	105,000	$31,364	1,248,218	362,143
Foreman-State National	11,000	11,000	2,508	151,296	7,065
Guaranty Trust	90,000	170,000	32,636	1,224,551	348,173
Second National	2,000	4,000	706	38,909	3,063
Emerson National	2,000	2,000	173	17,432	1,163
Morton Trust	1,500	1,000	217	14,988	469

* Includes undivided profits.

B. Balance Sheet, Kidder Peabody Acceptance Corporation, as of December 31, 1929 (000 omitted)

Assets	
Cash	$ 2,446
U. S. Government Bonds	3,812
Demand Loans (Secured by Acceptances)	1,400
Other Bankers' Acceptances	2,145
Notes and Accounts Receivable	1,939
Bonds	1,871
Stocks	3,370
Real Estate	107
Customers' Liability:	
On Acceptances	36,685
On Unused Letters of Credit	16,195
	$69,975
Liabilities*	
Capital Stock	$13,500
Acceptances Outstanding	38,361
Letters of Credit Outstanding	16,195
Reserve for Taxes and Dividends	184
Surplus	1,733
	$69,975

* Other bankers' acceptances sold with endorsement of this corporation, $7,006,946.

EXHIBIT 3

Outstanding Acceptances by American Bankers, as of December 31* (000 omitted)

Source	1925	1926	1927	1928	1929
Imports	$311,443	$283,587	$ 312,717	$ 315,614	$ 383,015
Exports	296,951	260,713	390,929	496,652	524,129
Domestic Shipment	25,606	28,686	20,959	16,198	22,830
Warehouse Credits	103,494	115,882	196,784	173,590	284,919
Dollar Exchange	19,248	26,179	28,316	39,153	76,285
Goods Stored in or Shipped between Foreign Countries	16,993	40,313	130,875	243,278	441,258
Total	$773,735	$755,360	$1,080,580	$1,284,485	$1,732,436

* Source: American Acceptance Council, *Acceptance Bulletin*, January 31, 1930, p. 18.

Should the name of the drawer or the nature of the transaction financed be relied upon in selecting acceptances for purchase?

Should acceptance holdings be diversified? If so, how?

What names, amounts, and maturities should have been purchased to make up the $300,000?

What determines whether or not an acceptance is "prime"?

Why should not the Tenth National Bank hold its own acceptances to maturity?

Assuming that the Tenth National Bank purchased $300,000 face value of prime acceptances on February 21, 1930, all acceptances being 180-day maturities, and that these acceptances were sold on March 8, 1930, when the rates on such acceptances were 3⅝% to 3½%, what effective yield per annum would have been secured on the investment?

What are the advantages of acceptances to the drawer, the acceptor, the buying bank, and the Federal reserve bank?

Why is the Federal reserve buying rate on acceptances lower than the rediscount rate on commercial paper? Why should the Federal reserve bank require that acceptances be endorsed? What determines whether or not an acceptance is eligible?

Has the increased use of acceptance credits supplanted other forms of financing?

Is it desirable that the use of acceptance credits be extended to include part of the domestic financing now handled through direct customer unsecured or commodity-secured loans?

Are there any reasons why a bank should purchase selected (or serial) maturities except when related to or governed by a prediction of cash needs based upon a study of the bank's experience in the past?

PROVIDENT BANK

APPRAISAL OF DEGREE OF LIQUIDITY POSSESSED BY EACH TYPE OF ASSET

At the meeting of the stockholders of the Federal Reserve Bank of Boston, held November 8, 1929, Federal Reserve Agent Frederic H. Curtiss said:

From time to time I have had occasion to discuss with executives of member banks an investment policy calculated to meet the changing conditions in the business done by their banks, and this has led to our having drawn up what we have come to call a liquidity chart . . . [see Exhibit 1]. You will notice that on this chart the assets of the bank have been divided into four classes:—*Primary Reserves*, *Secondary Reserves*, what we have termed a *Permanent Investment Fund*, and finally *Fixed Assets*. In laying out a policy of operation for a bank, I believe it is desirable to segregate a bank's investments and classify them in somewhat the manner that is outlined in this chart, and I have no doubt that many, and perhaps all of you, are doing something of this kind. Now, what proportion a bank should hold of each of these classes of assets depends, of course, on the character of a bank's business, —the stability of its demand and time deposits and other liabilities, and the size of its capital and surplus and the character of the accommodation it is called upon to furnish its customers . . .

The seasonal demand for credit on any particular bank and the seasonal fluctuation of its deposits call for a different diversity of investment than that of a bank in a suburban community, and therefore such a bank as the latter need not carry itself in as liquid a position as one in an active industrial community.

There are many of you who may disagree or have different views as to the classification of certain of the assets that are shown on this chart, for there has been much discussion among ourselves as to them, but I am presenting it in its present form in the hope that it may be of some help to you all in assisting you to solve the principal problem that must confront each of you, and that is, how to invest your money so that it may yield the highest return to your stockholders, and at the same time maintain a position of liquidity that will give your depositors the protection to which they are entitled . . . [1]

[1] In *Proceedings of the Seventh Annual Meeting of Stockholders of the Federal Reserve Bank of Boston*, pp. 13–15.

EXHIBIT 1

Liquidity Chart

Primary Reserves (Immediately Available without Loss or Depreciation of Principal or Interest)
- Vault Cash
- Collected Balance in Federal Reserve Bank
- Collected Balances in Other Banks
- Exchanges for Clearinghouse

Secondary Reserves (A Reserve with Somewhat Slower Availability, but Readily Usable)
- Notes Eligible for Rediscount with Federal Reserve Bank (Both as to Character and Maturity)
- Bankers' Acceptances (Eligible for Sale to Federal Reserve Bank)
- United States Securities Unpledged (Collateral for Loan at Federal Reserve Bank)
- Call Loans to Brokers (Properly Margined)
- Short-term Bonds
- Other Checks in Process of Collection, Etc.

Investment Fund
- Long-term Bonds
- Purchased Paper Ineligible for Rediscount
- Time Loans to Brokers
- Real Estate Loans
- Collateral Loans to Customers
- Notes of Customers (Not Eligible for Rediscount with Federal Reserve Bank)

Fixed Assets
- Bank Building
- Furniture and Fixtures
- Other Real Estate Owned

Analyze each item in the liquidity chart from the viewpoint of: (*a*) definition, (*b*) degree of liquidity, and (*c*) classification.

Should *rediscountable* but ineligible notes, *listed* long-term bonds, *demand* loans of customers, and *early* maturities of real estate loans and of time loans to brokers be counted as secondary reserve?

Trace in detail the sequence of economic events when banks proceed to liquidate each type of (*a*) customers' loans, and (*b*) noncustomers' loans.

Why is it thought desirable to have a considerable portion of noncustomers' loans in the portfolio? When all banks seek simultaneously to liquidate noncustomers' loans or bonds, what is the sequence of economic events?

To what extent does the shiftability to other banks of noncustomers' loans and bonds depend upon the contemporaneous policy of the Federal Reserve Board?

Are there any reasons why the shiftability of customers' loans should not be facilitated for member banks by the Federal reserve banks to the same extent as for noncustomers' paper?

3. LOANS BETWEEN CORRESPONDENT BANKS

AMERICAN NATIONAL BANK

CORRESPONDENT RELATIONSHIP[1]

The American National Bank, which was situated in a small city in the upper part of New York State, was organized early in 1929 with capital stock of $200,000 and paid-in surplus of $50,000. Shortly after the bank was opened, its president began receiving calls from Mr. Wallace and Mr. Reed, representatives of the Hempsted Trust Company of New York City and the Falls National Bank of Buffalo. After a few preliminary visits, each of these men began to solicit an account from the American National Bank, pointing out the advantages of establishing a correspondent relationship with the institutions which they respectively represented.

Mr. Wallace argued that every country bank should have a correspondent in New York City. He stated that an account with the Hempsted Trust Company, which was one of the largest institutions of its kind in the United States, would carry with it the following advantages:

1. A source of accurate credit information on any well-known name in the country, particularly important in making an intelligent choice of commercial paper.
2. The services of a highly organized foreign department, equipped to handle every kind of transaction in this field.
3. The aid of a thoroughly efficient bond department in buying and selling securities at the most advantageous prices, investment information for the bank and its customers, and an opportunity to obtain expert comment and advice regarding the bank's own bond list.

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[1] References for cases on correspondent banks: Watkins, L. L., *Bankers' Balances*, especially Ch. VII; Phillips, C. A., *Bank Credit*, Ch. XV; Westerfield, R. B., *Banking Principles and Practice*, revised printing, pp. 323–337, 481–494; Tippetts, C. S., *State Banks and the Federal Reserve System*, pp. 70–72, 197–208.

4. Safekeeping service for securities, including collection of interest, advices regarding called bonds, etc.

5. An agency through which funds may be placed in the New York call money market and in high-grade bankers' acceptances.

6. A convenient channel through which to draw New York exchange.

7. Suggestions, based on the long and successful operating record of the Hempsted Trust Company, regarding the most effective methods of advertising, securing new accounts, and conducting the various departments of the bank.

8. A means of handling desirable loans of any size, by passing on the excess over the American National Bank's lending limit to the Hempsted Trust Company.

9. A possible source of profitable business, owing to the nation-wide contacts and influence of the Hempsted Trust Company.

10. Direct borrowing accommodation at any time, provided proper collateral is offered.

11. Payment of interest on balances at the rates prescribed by the New York Clearing House, depending on the rediscount rate in force at the New York Federal Reserve Bank.

12. Information concerning economic conditions, tax laws, etc., from the published bulletins of the Hempsted Trust Company.

13. Railroad, steamship, and hotel reservations for trips to and from New York, and other personal services and entertainment during such visits.

When he was asked specifically about the borrowing arrangements which the Hempsted Trust Company made with its correspondents, Mr. Wallace stated that no lines of unsecured credit were ever granted to banks. Except in the most extraordinary situations, loans were made to correspondents only when they were secured by high-grade bonds or commercial paper and were adequately margined.[1] Although the condition of the borrowing bank and the size of the balances which it had kept were considered when an application for a loan was received, these factors were of secondary importance to the quality of the collateral offered. Mr. Wallace explained that the Hempsted Trust Com-

[1] The Hempsted Trust Company was willing to loan against bonds which were not acceptable as collateral at the Federal reserve bank. However, all security pledged had to be of high quality, and margins required varied with the liquidity of the collateral. The average collateral requirement of the Hempsted Trust Company was 120% of the amount of the loan.

pany did not make a practice of rediscounting the paper of correspondents' customers, regardless of whether or not this paper was eligible at the Federal reserve banks. The trust company believed that it was a mistake to allow a country bank to borrow against local receivables in order to raise more money to put back into the same type of risks. It felt that by so doing it would simply be encouraging correspondents to work themselves into a poorly diversified and nonliquid condition, with attendant danger to their solvency.

As a corollary to this attitude towards lending to banks, Mr. Wallace admitted that the Hempsted Trust Company usually did not feel a great responsibility when a correspondent became overextended. The trust company felt that, since it had encouraged conservatism on the part of correspondents, it had no obligation to save them from situations for which they alone were to blame.

Mr. Reed of the Falls National Bank stated that his bank was prepared to offer correspondents most of the services which had been enumerated by Mr. Wallace. However, in soliciting the account of the American National Bank, Mr. Reed laid particular stress on the desirability of having a city correspondent which appreciated the particular banking problems facing institutions in upper New York State. In regard to loans to country correspondents, Mr. Reed said that the Falls National Bank required bonds or commercial paper as collateral in ordinary times. However, the bank understood the seasonal requirements of correspondents in agricultural regions and was prepared to meet them by rediscounting selected customers' notes. Finally, the Falls National Bank was in a position to form well-founded judgments concerning the business of near-by correspondents, and would do everything in its power to help such correspondents in a "squeeze," provided that they had maintained good balances and had shown proper management.

The president of the American National Bank was in doubt regarding the desirability of a new correspondent relationship with a city bank. He believed that all ordinary borrowing requirements could be handled best through the Federal reserve bank, and that the same was true of collections. Furthermore, as a member bank, noninterest-bearing, legal reserves of 7% against demand and 3% against time deposits were being kept at the Federal reserve bank. Consequently, the president was reluctant to

establish the balance which would be required by a city correspondent and which could not be expected to return an average rate of more than 2% per annum.

If the American National Bank did decide to have a city correspondent, the president was certain that, for the present at least, only one such account should be established. He realized that there were a number of important services which only a New York City bank could perform directly, and that the Hempsted Trust Company offered more comprehensive facilities than did the Falls National Bank. At the same time, he knew that a correspondent in Buffalo would direct more collections and other business to the American National Bank than would a New York City institution and would be more apt to provide extraordinary rediscount facilities.

There was no reason to anticipate a run on the American National Bank. The president felt, however, that if he had a city correspondent which would rediscount his customers' receivables, it would be a form of insurance against a time when the bank was short of paper eligible at the Federal reserve bank. He believed that, in an emergency, the bank should be able to rediscount with its correspondent ineligible paper at least equal to $200,000, the amount of its capital stock.[1] He knew that excess loans would be taken by many correspondents and that the Falls National Bank had taken such loans on several occasions. In one instance, a run had been started on a small bank in a nearby town. This bank always had kept a good balance at the Falls National Bank, and the latter institution had saved its correspondent by shipping it $300,000 in gold coin and currency and taking over customers' paper as security for the amount so advanced. The president was doubtful whether the Hempsted Trust Company would consent to give aid under such circumstances, no matter how profitable the account of a correspondent had been in the past.

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[1] "No national banking association shall at any time be indebted, or in any way liable, to an amount exceeding the amount of its capital stock at such time actually paid in and remaining undiminished by losses or otherwise, except on account of . . . liabilities incurred under the provisions of the Federal Reserve Act . . . " *National Bank Act, as amended . . . July 1, 1933*, §432, Sec. 5202.

Despite this prohibition, national banks in practice may exceed this limit in their borrowing from correspondents. National bank examiners would criticize such violations precisely as they would the making of excess loans (*Ibid.*, §430, Sec. 5200) and bank directors knowingly violating these rules would be personally liable for any damages which might result therefrom to the bank or any other person (*Ibid.*, §731, Sec. 5239). See case of Beck & Bender, Incorporated, *supra.*

STILWELL NATIONAL BANK

LOANS TO CORRESPONDENT BANKS[1]

In February, 1930, two of the largest commercial banks in Chicago, the Stilwell National Bank and the Matson National Bank, were merged under the name of the Stilwell National Bank. Both banks acted as Chicago correspondents for a large number of smaller banks in the surrounding middle western territory, and one of the problems presented by the merger was the adoption of a uniform policy on loans to correspondent country banks. The policy of the Stilwell National Bank had been somewhat more rigorous than that of the Matson National Bank, so that the question in the majority of cases was whether or not changes should be made in the method of granting loans to the country banks which had been correspondents of the Matson National Bank previous to the merger. The following examples are typical of the cases which came up for discussion and decision:

1. *Maytown National Bank.*—This institution was the largest bank in Maytown, a manufacturing city in southern Wisconsin. The manufacture of hosiery and underwear constituted the city's chief industry, and, because of the depressed condition of this industry, deposits of the Maytown National Bank had declined gradually over a period of years. The management of the bank was conspicuously able, and the board of directors was made up of the leading business men of Maytown. With these men the officers and directors of the Matson National Bank were personally acquainted in many cases.

The Maytown National Bank had borrowed frequently from the Matson National Bank, but such loans were only for short periods and were usually for the purpose of adjusting the position of the Maytown National Bank at the Federal Reserve Bank of Chicago. The Maytown National Bank endeavored to pay off its borrowings in those months in which it expected a call of condition.

[1] For the analysis of credit risks in loans to banks, see: Paul, W. E., "Ratio Analysis and Control of Resources and Liabilities," *Proceedings of Departmental Conferences*, American Institute of Banking, June, 1930, pp. 74–90; Trant, J. B., *Bank Administration*, Chs. XIII–XIV.

Statements of condition for five different dates are given in Exhibit 1. During 1929 the Maytown National Bank had borrowed nine times from the Matson National Bank. The largest amount borrowed was $400,000, and the smallest, $100,000.

EXHIBIT 1

Statements of Condition—Maytown National Bank
(000 omitted)

	December 31, 1928	March 27, 1929	June 29, 1929	October 4, 1929	December 31, 1929
Resources					
Cash, Exchange, and Due from Banks	$1,100	$ 885	$1,061	$ 922	$1,100
United States Securities	200	200	200	200	200
Other Bonds	3,466	3,529	3,485	3,669	3,443
Loans and Discounts	4,875	4,828	4,375	4,238	4,382
Other Assets	260	265	261	260	253
Total	$9,901	$9,707	$9,382	$9,289	$9,378
Liabilities					
Capital	$ 500	$ 500	$ 500	$ 500	$ 500
Surplus and Undivided Profits	668	718	684	738	716
Deposits	8,587	8,080	8,060	7,934	8,035
Bills Payable	.. ..	300	.....	.....	.....
Other Liabilities	146	109	138	117	127
Total	$9,901	$9,707	$9,382	$9,289	$9,378

In the majority of instances, the loans were secured by the pledge of high-grade bonds as collateral, but occasionally, when the Maytown National Bank needed funds for one or two days to bring up its average reserve, the loan was made on an unsecured demand note. The Matson National Bank had occasionally loaned to the Maytown National Bank, on this temporary basis, amounts in excess of the latter bank's capital. On the bond-secured loans, the customary margin was 10%, and on all loans the Maytown National Bank received the lowest rate, ½ of 1% above the rediscount rate of the Federal Reserve Bank of Chicago. During 1929 the loanable balance of the Maytown National Bank at the Matson National Bank had averaged $164,000 and had ranged between a high of $247,000 and a low of $102,000. Interest was paid on this balance. The Maytown National Bank's account showed a normal activity.

2. *Forbes Trust Company.*—This bank was located in a small city in northern Illinois. There were several industrial plants in the city, but the main source of income was mixed farming and dairying. Consequently, there was no marked seasonal change in the income of the bank's customers throughout the year. The Forbes Trust Company had been organized in 1915 by a group of

individuals of high standing in the community but with little banking experience. A liberal loan policy had been adopted, and in early 1930 approximately 75% of the loans were on real estate. The bond account of the bank was made up of high-grade bonds, the bulk of which had been purchased in the years 1926 to 1928. As a result, the total book value of the bond account was substantially above the total market value in 1929, and substantial liquidation of bonds would entail serious losses.

The Forbes Trust Company kept part of its bonds in a safekeeping account at the Matson National Bank, and these bonds were pledged as collateral for the loans made by the Matson National Bank. The Forbes Trust Company had been continuously in debt to the Matson National Bank for over a year and a half. Borrowings were somewhat higher in the winter than during the remainder of the year. In 1929 the average amount loaned was $137,000, and the maximum and minimum figures were $210,000 and $65,000, respectively.

The loanable balance in the account of the Forbes Trust Company at the Matson National Bank fluctuated between $12,000 and $40,000, and the activity of the account was not excessive. A 10% margin was required on loans, and the customary rate was

EXHIBIT 2

Statements of Condition—Forbes Trust Company
(000 omitted)

	December 31, 1928	March 30, 1929	September 30, 1929	December 31, 1929
Resources				
Cash, Exchange, and Due from Banks	$ 76	$ 66	$ 86	$ 43
Bonds	525	526	531	510
Loans (Including Mortgages)	1,000	1,037	1,106	1,134
Other Assets	82	70	71	78
Total	$1,683	$1,699	$1,794	$1,765
Liabilities				
Capital	$ 50	$ 50	$ 50	$ 50
Surplus and Undivided Profits	70	74	75	66
Deposits	1,415	1,472	1,529	1,450
Bills Payable	140	100	135	180
Other Liabilities	8	3	5	19
Total	$1,683	$1,699	$1,794	$1,765

1% above the rediscount rate. Figures for the Forbes Trust Company are given in Exhibit 2.

3. *Farmers' State Bank.*—This bank was located in Minnesota in an agricultural area where the farmers were primarily dependent upon one crop for their livelihood. If this crop was a failure in one year, the Farmers' State Bank carried the farmers through to the next harvest, and if this harvest also was disappointing, the bank again was obliged to extend the loans to the next harvest. In each case, new money had to be advanced to enable the farmers to put in a crop. In good crop years, the farmers who borrowed in the spring paid off their loans in the fall. Under such favorable conditions, the customers' loans of the Farmers' State Bank on December 31 were low and the deposits high.

The Matson National Bank loaned to the Farmers' State Bank in order to enable the country bank to supply the seasonal credit demands of its community. Ordinarily, these loans were paid off in the late fall and early winter, but, when there was a succession of bad years, the loans were carried over from season to season. As security for the loans, the Farmers' State Bank pledged farmers' notes. The margin required on such loans was 40%, and the Farmers' State Bank customarily paid a rate 1½% above the rediscount rate. The Matson National Bank never had required the Farmers' State Bank to furnish any information or statements in regard to the borrowers whose notes were accepted as collateral. The balance in the account of the Farmers' State Bank at its Chicago correspondent bank depended upon the agricultural situation. In 1928 the loanable balance averaged $23,000, whereas in 1929 this balance varied between $46,000 in April and $111,000 in December.

EXHIBIT 3

Selected Figures—Farmers' State Bank

(000 omitted)

	June 30, 1926	December 30, 1926	December 30, 1927	June 30, 1928	December 30, 1928	June 30, 1929	December 30, 1929
Cash, Exchange, and Due from Banks	$ 175	$ 100	$200	$ 71	$ 75	$110	$237
Investments	450	475	390	272	270	300	314
Loans and Discounts	450	600	672	783	784	774	684
Capital, Surplus, and Undivided Profits	146	155	150	160	158	155	160
Deposits	1,000	1,000	900	800	700	700	950
Bills Payable	......	......	199	100	360	321	170

The figures given in Exhibit 3 show the dependence of the Farmers' State Bank upon crop conditions. The first date, June, 1926, found the farmers fairly well supplied with money after a good year. The 1926 crop also was profitable, but in 1927 began a succession of bad years, and it was not until December, 1929, after the excellent harvest of that year, that the position of the bank showed any considerable improvement.

Criticize the loan policy of the Matson National Bank from the standpoints of: (*a*) kinds of collateral security, (*b*) margin requirements, and (*c*) rates charged.

What measures, if any, should be taken to facilitate the liquidation of the indebtedness of the Forbes Trust Company?

Should the Stilwell National Bank continue the policy of extending the loans of the Farmers' State Bank when crops are unfavorable? Is this one of the functions of a city correspondent? Are there other agencies for the performance of this function?

Are the changes in loans and deposits of the Farmers' State Bank typical of country banks in Minnesota?

Upon what terms, and to what extent, should these three "lines" be continued? Formulate a statement of the principles, or rules, to be followed in making loans to correspondent banks.

MERRILL v. NATIONAL BANK OF JACKSONVILLE

173 U. S. 131; 19 Sup. Ct. 360 (1899)[1]

RIGHTS OF HOLDERS OF COLLATERAL FOR LOANS TO NATIONAL BANKS WHICH BECOME INSOLVENT

. . . On the seventeenth day of July, A. D. 1891, the First National Bank of Palatka, Florida . . . failed . . . Merrill was duly appointed receiver of the bank . . . [The bank] was indebted to the National Bank of Jacksonville in the sum of $6,010.47 . . . unsecured; and also in the sum of $10,093.34, being $10,000, and interest, . . . evidenced by a certificate of deposit, which was secured by sundry notes belonging to the First National Bank of Palatka . . . The National Bank of Jacksonville proved its claim . . . for $6,010.47 . . . It also offered to prove its claim for $10,093.34, but the receiver would not permit it to do this, and, under the ruling of the Comptroller of the Currency, it was ordered first to exhaust the collaterals given to secure the certificate of deposit, and then to prove for the balance due . . .

The Jacksonville Bank collected all the notes excepting [one of them] . . . applied the proceeds of the collaterals which it had collected to its claim . . . and proved for the balance due thereon, being the sum of $4,496.44 . . .

On the eleventh of September, 1894, the Jacksonville Bank . . . complained of the action of the receiver in not permitting proof for the full amount of the certificate of deposit, and alleged that it "gave due notice that it would demand a *pro rata* dividend upon the whole amount . . . without deducting the amount collected on collateral security . . . "

Mr. Chief Justice Fuller . . . delivered the opinion of the Court . . .

The inquiry on the merits is, generally speaking, whether a secured creditor of an insolvent national bank may prove and receive dividends upon the face of his claim as it stood at the time of the declaration of insolvency, without crediting either his collaterals, or collections made therefrom after such declaration,

[1] Portions of this case are omitted.

subject always to the proviso that dividends must cease when, from them and from collaterals realized, the claim has been paid in full.

Counsel agree that four different rules have been applied in the distribution of insolvent estates, and state them as follows:

Rule 1. The creditor desiring to participate in the fund is required first to exhaust his security and credit the proceeds on his claim, or to credit its value upon his claim and prove for the balance, it being optional with him to surrender his security and prove for his full claim.

Rule 2. The creditor can prove for the full amount, but shall receive dividends only on the amount due him at the time of distribution of the fund; that is, he is required to credit on his claim, as proved, all sums received from his security, and may receive dividends only on the balance due him.

Rule 3. The creditor shall be allowed to prove for, and receive dividends upon, the amount due him at the time of proving or sending in his claim to the official liquidator, being required to credit as payments all the sums received from his security prior thereto.

Rule 4. The creditor can prove for, and receive dividends upon, the full amount of his claim, regardless of any sums received from his collateral after the transfer of the assets from the debtor in insolvency, provided that he shall not receive more than the full amount due him.

The circuit court and the circuit court of appeals held the fourth rule applicable, and decreed accordingly . . .

The first rule is commonly known as the "bankruptcy rule," because enforced by the bankruptcy courts in the exercise of their peculiar jurisdiction, under the bankruptcy acts, over the property of the bankrupt, in virtue of which creditors holding mortgages or liens thereon might be required to realize on their securities, to permit them to be sold, to take them on valuation, or to surrender them altogether, as a condition of proving against the general assets.

The fourth rule is that ordinarily laid down by the chancery courts, to the effect that, as the trust created by the transfer of the assets by operation of law or otherwise is a trust for all creditors, no creditor can equitably be compelled to surrender any other vested right he has in the assets of his debtor in order to obtain his vested right under the trust . . .

. . . the secured creditor is not to be cut off from his right in the common fund because he has taken security which his co-creditors have not. Of course, he cannot go beyond payment, and surplus assets or so much of his dividends as are unnecessary to pay him must be applied to the benefit of the other creditors . . .

We cannot concur in the view expressed by Chief Justice Parker in Amory v. Francis, 16 Mass. 308 (1820), that "the property pledged is in fact security for no more of the debt, than its value will amount to; and for all the rest, the creditor relies upon the personal credit of his debtor, in the same manner he would for the whole, if no security were taken."

We think the collateral is security for the whole debt and every part of it, and is as applicable to any balance that remains after payment from other sources as to the original amount due, and that the assumption is unreasonable that the creditor does not rely on the responsibility of his debtor according to his promise . . .

Does the legislation in respect to the administration of national banks require the application of the bankruptcy rule? If not, we are of opinion that the equity rule was properly applied in this case . . .

Section 5236 [of the Revised Statutes, with reference to insolvent National Banks] is as follows:

> From time to time, . . . the Comptroller shall make a ratable dividend of the money so paid over to him by such receiver on all such claims as may have been proved to his satisfaction, or adjudicated in a court of competent jurisdiction, . . . and the remainder of the proceeds, if any, shall be paid over to the shareholders of such association . . .

In Cook County Nat. Bank v. U.S., 107 U.S. 445, 2 Sup. Ct. 561, it was ruled that the statute furnishes a complete code for the distribution of the effects of an insolvent national bank; that its provisions are not to be departed from; and that the bankrupt law does not govern distribution thereunder . . . The distribution is to be "ratable" on the claims as proved or adjudicated; that is, on one rule of proportion applicable to all alike. In order to be "ratable," the claims must manifestly be estimated as of the same point of time, and that date has been adjudged to be the date of the declaration of insolvency. White v. Knox, 111 U.S. 784, 4 Sup. Ct. 686 . . .

The rule in bankruptcy went upon the principle of election; that is to say, the secured creditor "was not allowed to prove his whole debt, unless he gave up any security held by him on the estate against which he sought to prove. He might realize his security . . . and might prove for any deficiency of the proceeds to satisfy his demand; but if he neglected to do this, and proved for his whole debt, he was bound to give up his security." Rob.

Bankr. 336. But it was only under bankrupt laws that such election could be compelled. Tayloe v. Thompson, 5 Pet. 358, 369.

And we are unable to accept the suggestion that compulsion under those laws was the result merely of the provision for ratable distribution, which only operated to prevent preferences . . .

The case was rightly decided by the circuit court of appeals . . .

Mr. Justice WHITE, with whom concurred Mr. Justice HARLAN and Mr. Justice McKENNA, dissenting . . .

As the universal rule and practice in bankruptcy in England and in this country, up to and including the bankrupt act of 1841, was solely the result of the statutory requirement that the assets should be ratably distributed among the general creditors, my mind fails to discern why the requirement for ratable distribution of the assets in the act for the liquidation of failed national banks should not . . . produce the same result as the substantially similar provisions had always meant and had always operated in England for hundreds of years and in this country for many years before the adoption by Congress of the act for the liquidation of national banks . . .

. . . the reasoning to which we have referred rests upon the assumption that the act of Congress providing for the liquidation of the affairs of a national bank and a distribution of the assets thereof among the creditors is not substantially a bankrupt statute. It certainly is a compulsory method provided by law for winding up the concerns of an insolvent bank, for preventing preferences, and for securing an equal and ratable division of the assets of the association among its creditors . . .

[Mr. Justice GRAY wrote a separate dissenting opinion.]

Appraise both the particular and general effects upon bank credit policy of the conclusion reached in this case.

Is it good public policy for any secured creditors of *national* banks to have the right granted in this case?

II

LOANS

4. CUSTOMERS' UNSECURED LOANS

OGDEN STAMPING COMPANY

EXTENSION OF CREDIT TO A METALS MANUFACTURER—RATIO ANALYSIS OF STATEMENTS[1]

In February, 1925, the Ogden Stamping Company of Flint, Michigan, manufacturers of dies and pressed steel parts used in the production of automobiles, asked the St. Clair National Bank of Detroit for an unsecured credit line of $200,000. In reaching a decision on this request, the officer of the bank who handled the account considered the company's financial history, shown in Exhibit 1, and also the bank's experience with the account.

The relationship of the bank with the company had begun in January, 1921, when an account had been opened in consideration of a loan of $125,000 to finance an anticipated expansion in production and sales. This initial loan had been granted after a review of the company's 1920 statement, which showed satisfactory proportions and excellent earning ability. At the same time another bank had loaned the company a moderate amount.

Depressed business conditions in 1921 caused the company to experience a loss, and bank loans were not paid off as expected. Upon request, the banks extended their loans because it was thought that the situation was temporary and that the statement did not show a critical position.

Profits were earned during 1922, but the company did not acquire sufficient working capital thereby to make possible complete payment of the bank loans.

The year 1923 gave promise that the loans would be paid off. Early in that year the company obtained several substantial new

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[1] On credit analysis and administration, see: Knight, F. H., *Risk, Uncertainty and Profit*, Ch. VIII; Dunkman, W. E., *Qualitative Credit Control*, Chs. IX–XI; Phillips, C. A., *Bank Credit*, Chs. VII–XI; Wall, Alexander, *How to Evaluate Financial Statements;* Bliss, J. H., *Financial and Operating Ratios in Management*, Chs. VI–XXVI; Daniels, M. B., *Corporation Financial Statements*, Michigan Business Studies, Vol. VI, No. 1, especially Chs. II; III, IV, VII, VIII, XI, XIII, and XIV; Prochnow and Foulke, *Practical Bank Credit;* Schluter, W. C., *Credit Analysis*, especially Chs. VI–XIII; Ebersole, J. F., *Bank Management—A Case Book*, first edition, Biggers & Fuller Woolen Company; American Bankers Association, *Commercial Bank Management Booklet No. 7, Credit Department Organization.*

orders, and the St. Clair National Bank agreed to loan \$60,000 for working capital in addition to the \$125,000 already outstanding. It was expected that the profit upon the increased volume would make possible payment of all loans by the end of 1923. However, the company made no reduction of the bank loans

EXHIBIT 1

Financial Statements of the Ogden Stamping Company, as of December 31, 1920 to 1924*

	1920	1921	1922	1923	1924
Assets					
Cash	\$ 314,486	\$ 439,894	\$ 265,069	\$ 716,809	\$ 26,829
Notes and Accounts Receivable	651,660	540,789	361,590	352,358	578,382
Merchandise	1,133,533	820,860	685,377	806,440	777,449
Current Assets	\$2,099,679	\$1,801,543	\$1,312,036	\$1,875,607	\$1,382,660
Land, Buildings, and Equipment, Net	2,952,235	2,975,510	3,345,965	3,441,442	3,148,912
Investments	65,750	65,750	65,750	65,750	68,708
Patents	106,513	106,513	106,513	106,513	106,513
Sundry Accounts Receivable	291,368	390,222	366,895	176,264	177,155
Deferred Charges, Etc.	44,190	8,027	7,942	24,895	29,951
Total Assets	\$5,559,735	\$5,347,565	\$5,205,101	\$5,690,471	\$4,913,899
Liabilities					
Notes Payable—Banks	\$ 250,000	\$ 687,500	\$ 687,500	\$1,250,000	....
Accounts Payable	105,891	99,159	135,821	48,463	\$ 106,644
Payrolls and Sundry	362,335	284,095	67,746	49,336	82,134
Due Officers and Stockholders	10,616	9,711	1,580	5,326	126,540
Current Liabilities	\$ 728,842	\$1,080,465	\$ 892,647	\$1,353,125	\$ 315,318
Preferred Stock	1,250,000	1,212,500	1,212,500	1,212,500	1,207,500
Common Stock	625,000	625,000	625,000	625,000	625,000
Surplus	2,955,893	2,429,600	2,474,954	2,499,846	2,766,081
Total Liabilities	\$5,559,735	\$5,347,565	\$5,205,101	\$5,690,471	\$4,913,899
Sales	\$3,971,774	\$1,789,054	\$2,680,588	\$4,358,506	\$3,653,213
Net Profits	876,613	137,990(d)	145,380	108,828	335,828
Dividends Paid	600,000	223,000	97,000	97,000	....
Current Ratio	2.88–1	1.67–1	1.47–1	1.39–1	
Net Worth—Debt	6.63–1	3.95–1	4.83–1	3.21–1	
Net Worth—Fixed Assets	1.64–1	1.43–1	1.29–1	1.26–1	
Merchandise—Receivables	1.20–1	.88–1	.94–1	1.53–1	
Sales—Receivables	4.21–1†	1.92–1‡	3.68–1§	8.25–1‖	
Sales—Merchandise	3.50–1	2.18–1	3.91–1	5.40–1	
Sales—Net Worth	.82–1	.42–1	.62–1	1.00–1	
Sales—Fixed Assets	1.35–1	.60–1	.80–1	1.27–1	
Profit on Sales	22.07%	....	5.42%	2.50%	
Profit on Net Worth	18.15%	....	3.37%	2.51%	
Acid Test	1.33–1	.91–1	.70–1	.79–1	

* Audited.
† 87 days.
‡ 190 days.
§ 99 days.
‖ 44 days.
(d) Deficit.

and the year-end figures were not satisfactory. Accordingly, early in 1924, the banks which held the notes of the company formed a committee to determine the reasons for the poor showing. Careful examination by the committee revealed that the plant had been operated very inefficiently. As a result, the banks

refused to renew the notes of the company until a satisfactory plant manager had been employed.

Almost immediately after the new manager took charge, changes were made which resulted in large savings in manufacturing costs despite considerable speeding up of production schedules. By the midsummer of 1924, the company began to reduce its indebtedness to banks. At the end of the year, all bank loans had been paid and none of the company's accounts payable were overdue.

In submitting its statement of December 31, 1924, the company informed the bank that loans would be needed to finance a summer peak, and that a "cleanup" of the indebtedness would be made before the end of 1925.

For the purpose of directing special attention in this case to the method of ratio analysis:

(*a*) Compute the ratios for the 1924 statement and justify the selection of items used in the derivation of each ratio.[1]

(*b*) State whether an increase or decrease of each ratio should be regarded as favorable.

(*c*) Describe the probable changes in the ratios shown after the occurrence of any one of the following: more liberal anticipation of needs for raw material, increased volume of production, expansion of credit terms granted customers, less prompt payment of accounts payable, smaller bank balances, payment of bank loans, increased profitability of sales, and larger contracts for goods to be delivered in the future.

(*d*) For each year, estimate the average number of days funds are required to finance a sale from the time raw material is supplied until the customer makes payment.

(*e*) Name the most desirable statement dates for use in judging credit.

(*f*) Appraise the relative value of each ratio in judging the safety and liquidity of the amount of bank credit used by any borrower. Does the type of industry being considered affect the relative value of the ratios?

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[1] Unless especially noted, all ratios appearing in this book are based on the same selection of items. The student may from time to time find other selections more useful for his analysis. Particularly, he should be aware that the net worth-fixed assets ratio as computed may be misleading when the plant item is not predominant among the noncurrent assets. Why do many bankers compute credit ratios to the second decimal place?

(*g*) Describe the changes in the company's position as revealed by the method of ratio analysis.

(*h*) From what sources did the funds come which were used to pay the banks in 1924?

(*i*) Should the Ogden Stamping Company be granted a $200,000 line for 1925? Is there assurance that a loan of this amount would be paid?

TWING PACKING COMPANY

EXTENSION OF CREDIT TO A MEAT PACKING COMPANY—COMPARISON WITH OTHER CONCERNS IN THE SAME TRADE

When the *Trade Statement Studies*, December 31, 1935, of the Robert Morris Associates[1] arrived at the First Bank in Akron, Ohio, in June, 1936, Mr. Gray, manager of the credit department, made a study of the position of the Twing Packing Company in relation to the industry as a whole.

The Twing Packing Company, an old, well-established concern, engaged primarily in the packing of beef and pork, had opened an account with the First Bank in 1923. The bank was not a principal depositary of the company. Consequently, balances had averaged $9,100 in 1932, $7,000 in 1933, $6,200 in 1934, and $11,700 in 1935. Much of the company's borrowed funds had been obtained from commercial paper, sold with the protection of lines of credit from several banks. In 1935, however, the company had borrowed from the First Bank for five months, the peak amount of $100,000 being outstanding from April through July. Financial statements for the Twing Packing Company are given in Exhibit 1.

The usual line of credit had been extended for the year 1936, but, because of decreases in the current ratio and in profits, Mr. Gray had marked the account for further study when industry figures should become available. If the company appeared to be retrograding relative to the industry, he thought it likely that the bank might wish to reduce the line of credit.

For comparative purposes, Mr. Gray used first the ratios for the meat packing industry, which he found in the Robert Morris

[1] Robert Morris Associates, Philadelphia, is composed of financial credit men. Members can have figures of particular companies compared with annual studies of the same type of business. Also, an annual booklet of "common-size" balance sheets, income statements, and ratios is sent to members.

EXHIBIT 1

Financial Statements of Twing Packing Company, 1932 to 1935*
(000 omitted)

	October 29, 1932	October 28, 1933	October 27, 1934	November 2, 1935
Assets				
Cash	$ 387†	$ 346	$ 387	$ 774
Accounts Receivable	853	1,072	1,362	1,478
Merchandise—Finished (market less cost of selling)	1,551	1,791	2,910	2,072
Livestock and Supplies				805
Cash Value Life Insurance	....	....	42	49
Federal Relief Corporation and Government Agencies	....	....	183	....
Current Assets	$ 2,791	$ 3,209	$ 4,884	$ 5,178
Land, Buildings, and Equipment—Net	3,401	3,478	3,462	3,823
Investments	32‡	52‡	17	17
Deferred Charges and Prepaid Items	92	119	140	34
Miscellaneous Receivables	....	....	77	101
Total Assets	$ 6,316	$ 6,858	$ 8,580	$ 9,153
Liabilities				
Notes Payable for Borrowed Money	....	$ 328	$ 983	$ 200
Notes Payable for Merchandise	....	....	....	15
Accounts Payable	$ 73	192	166	21
Processing Taxes Payable	....	....	938	2,451
Dividends, Accruals, Taxes, and Miscellaneous	141	173	304	85
Current Liabilities	$ 214	$ 693	$ 2,391	$ 2,772
6% Preferred Stock	....	....	....	588
7% Preferred Stock	2,125	2,120	2,117	2,117
Common Stock	2,000	2,000	2,000	2,000
Earned Surplus	1,977	2,045	1,562	1,165
Paid-in Surplus	....	....	510	511
Total Liabilities	$ 6,316	$ 6,858	$ 8,580	$ 9,153
Sales	$18,690	$19,065	$25,734	$34,938§
Net Profits	403	617	756	83§
Dividends	....	548	549	467

* Audited.
† Includes United States Government bonds.
‡ Includes cash value of life insurance.
§ For 53 weeks.

Associates booklet.[1] The ratios for the company and the "selected ratios" of the Robert Morris Associates for the "trade" are given in Exhibit 2. By the use of their "reconstruction sheet," he

[1] As of June 1, 1940, the ratios of the Robert Morris Associates were computed from figures obtained from members, who transferred customers' balance sheets and

EXHIBIT 2

Comparison of Ratios of Twing Packing Company with "Selected Ratios" for Meat Packers Compiled by Robert Morris Associates*

	1932	1933	1934	1935
Current Ratio				
Twing Packing Company	1304	463	204	187
Robert Morris Associates Trade Figures	600	500	325	320
Net Worth to Fixed Assets				
Twing Packing Company	173	169	167	161
Robert Morris Associates Trade Figures	120	125	115	130
Net Worth to Debt				
Twing Packing Company	2851	890	259	230
Robert Morris Associates Trade Figures	300	270	200	200
Sales to Receivables				
Twing Packing Company	2191	1778	1889	2364
Robert Morris Associates Trade Figures	2100	1900	1800	2000
Sales to Merchandise				
Twing Packing Company	1205	1064	884	1214
Robert Morris Associates Trade Figures	1300	1100	1000	1100
Sales to Fixed Assets				
Twing Packing Company	530	522	696	879
Robert Morris Associates Trade Figures	325	390	400	500
Sales to Net Worth				
Twing Packing Company	306	309	416	548
Robert Morris Associates Trade Figures	260	225	345	400
Profits on Net Worth				
Twing Packing Company	6.6	10.0	12.2	1.3
Robert Morris Associates Trade Figures	.3†	4.5	5.0	3.5
Profits on Sales				
Twing Packing Company	2.2	3.2	2.9	.2
Robert Morris Associates Trade Figures	.0	1.6	1.1	.7

* Figures compiled from the returns of 31 meat packing concerns in 1932, 32 in 1933, 40 in 1934, and 42 in 1935. In this table the ratios (and profits) are expressed as relatives to 100.
† Loss.

sought to discover points of greater or less investment in the Twing Packing Company than was typical in the industry. The industry proportions were applied to the total figure on the company

profit and loss statements to a prepared form, thereby obtaining a uniform classification of items. At the headquarters of the Robert Morris Associates, statements were accumulated by industries and a number of significant ratios calculated. Each ratio (such as sales to receivables) was then ranked with similar ratios for the other companies in the same industry. The modal and median classes, and, if the number of statements was large, the quartiles, were found. The reported figures for the companies in each industry were totaled by items to form an aggregate balance sheet for the industry which was adjusted to "common size" by expressing each item as a percentage of total assets. From this common-size statement, ratios were then computed.

Prior to 1937, the ratio finally selected and published was an arithmetic average of (1) the average of the modal group, (2) the median ratio, and (3) the ratio from the common-size statement.

Beginning with 1937, the "selected ratios" have not been published. Instead the annual booklet presented "ratio range" tables which included, where possible, the following: arithmetic average, lower quartile, median, upper quartile, mode.

EXHIBIT 3

Reconstruction Sheet of Twing Packing Company, Based on Total Resources,* November 2, 1935

	Actual†	Type‡	Adjusted†	Over†	Under†
Assets					
Cash	$ 774	8.41%	$ 770	$ 4	......
Receivables	1,478	12.33	1,129	349	......
Merchandise Inventory	2,877	29.35	2,686	191	......
Marketable Securities	....	1.96	179	......	$ 179
Miscellaneous	49	.17	16	33	......
Total Current	$ 5,178	52.22%	$ 4,780	398	......
Plant and Equipment	$ 3,823	37.70%	$ 3,451	372	......
Prepaid and Deferred Accounts	34	.89	81	......	47
Miscellaneous	118	9.19	841	......	723
Total Noncurrent	$ 3,975	47.78%	$ 4,373	......	398
Total	$ 9,153	100.00%	$ 9,153	......	......
Liabilities					
Due to Banks	$ 200	1.86%	$ 170	$ 30	......
Due to Trade	36	2.45	224	......	$ 188
Taxes	2,468	5.47	501	1,967	......
Miscellaneous	68	2.52	231	......	163
Total Current	$ 2,772	12.30%	$ 1,126	1,646	......
Funded Debt	....	18.15	1,661	......	1,661
Total Debt	$ 2,772	30.45%	$ 2,787	......	15
Reserves	....	5.62	514	......	514
Net Worth	6,381	63.93	5,852	529	......
Total	$ 9,153	100.00%	$ 9,153	......	......
Sales	$34,938	239.54%	$21,925	......	......
Profit before Dividends	83	2.85	261	......	......

* A similar reconstruction sheet may be based on sales.
† Thousands omitted.
‡ 42 companies.

balance sheet, thereby setting up figures for a theoretical company having the same size as that of the Twing Packing Company, but with the proportionality among assets and liabilities common to the industry as shown by the trade figures. Differences calculated between the company's statement and the computed statement which was used as a criterion are shown in Exhibit 3. The balance sheet proportions of the Twing Packing Company were compared with the Robert Morris Associates common-size figures of the industry for several past years. A tabulation of these proportions is given in Exhibit 4.

In addition, Mr. Gray made use of another tool of analysis of the Robert Morris Associates. In essence, ratios of the company

EXHIBIT 4

Comparison of Proportions of Twing Packing Company Annual Balance Sheets with Appropriate Common-size Statements of Robert Morris Associates for Meat Packing Companies, as of about December 31, 1932 to 1935*

	1932		1933		1934		1935	
	Twing Company	Common Size	Twing Company	Common Size	Twing Company	Common Size	Twing Company	Common Size
Assets								
Cash	6.13	9.62	5.04	7.91	4.51	5.13	8.46	8.41
Receivables	13.50	8.87	15.63	10.42	15.87	11.81	16.15	12.33
Merchandise	24.56	17.04	26.12	21.88	33.92	29.76	31.43	29.35
Marketable Securities	....	3.28	......	2.54	....	1.10	......	1.96
Miscellaneous	....	.17	......	.18	1.62	.60	.53	.17
Total Current	44.19	38.98	46.79	42.93	56.92	48.40	56.57	52.22
Plant and Equipment	53.84	†	50.71	47.07	40.35	42.89	41.77	37.70
Deferred Accounts	1.46	†	1.74	1.09	1.63	.68	.37	.89
Miscellaneous	.51	†	.76	8.91	1.10	8.03	1.29	9.19
Total Fixed	55.81	61.02	53.21	57.07	43.08	51.60	43.43	47.78
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Liabilities								
Due to Banks	....	4.75	4.78	2.09	11.46‡	2.59	2.19	1.86
Due to Trade	1.16		2.80	3.19	1.94	3.03	.39	2.45
Taxes	1.06	.08	1.50	.92	12.40	3.89	26.97	5.47
Miscellaneous	1.17	.62	1.02	1.48	1.98	1.62	.74	2.52
Total Current	3.39	5.45	10.10	7.68	27.87	11.13	30.29	12.30
Funded Debt	....	22.17	......	20.28	....	27.39	.....	18.15
Total Debt	3.39	27.62	10.10	27.96	27.87	38.52	30.29	30.45
Reserves	....	1.83	......	2.37	......	3.05	......	5.62
Net Worth	96.61	70.55	89.90	69.67	72.13	58.43	69.71	63.93
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Sales	295.92	162.00	278.00	156.90	299.03	198.51	381.71	239.54
Profit before Dividends	6.38	1.27§	9.00	4.54	8.81	2.90	9.07	2.85

* Figures compiled from the returns of 31 meat packing concerns in 1932, 32 in 1933, 40 in 1934, and 42 in 1935.
† Not reported.
‡ Includes a small portion of loans from officers and stockholders.
§ Loss.

and of the industry were weighted and combined in such a way as to give a single composite index showing the trend of the company's position in relation to the industry without regard to whether the industry itself was going up or down. The results of applying this method to the Twing Packing Company are presented in Exhibit 5.

For the purpose of directing attention particularly in this case to the method of comparing a single concern with other concerns in the same business, state concisely whether the Twing Packing Company is advancing or retrograding, and whether it is satisfactory or unsatisfactory as a credit risk relative to the following:

(*a*) Current position.
(*b*) Dependence on borrowed money.

EXHIBIT 5

Computation of Index of Twing Packing Company in Relation to Industry*

		1932				1933			
	Weight	Company	Industry Base	Relative	Value	Company	Industry Base	Relative	Value
Current Ratio	25 %	1304	600	154	38.50	463	500	93	23.25
Net Worth to Fixed Assets	15	173	120	131	19.65	169	125	126	18.90
Net Worth to Debt	25	2851	300	189	47.25	890	270	170	42.50
Sales to Receivables	10	2191	2100	104	10.40	1778	1900	94	9.40
Sales to Merchandise	10	1205	1300	93	9.30	1064	1100	97	9.70
Sales to Fixed Assets	10	530	325	139	13.90	522	390	125	12.50
Sales to Net Worth	5	306	260	115	5.75	309	225	127	6.35
Index					144.75				122.60

		1934				1935			
	Weight	Company	Industry Base	Relative	Value	Company	Industry Base	Relative	Value
Current Ratio	25 %	204	325	63	15.75	187	320	58	14.50
Net Worth to Fixed Assets	15	167	115	131	19.65	161	130	119	17.85
Net Worth to Debt	25	259	200	123	30.75	230	200	113	28.25
Sales to Receivables	10	1889	1800	105	10.50	2364	2000	115	11.50
Sales to Merchandise	10	884	1000	88	8.80	1214	1100	109	10.90
Sales to Fixed Assets	10	696	400	143	14.30	879	500	143	14.30
Sales to Net Worth	5	416	345	117	5.85	548	400	127	6.35
Index					105.60				103.65

* In computing the relatives, the smaller of the company and the corresponding industry base ratio figures were divided by the larger of the two. If the company figure was less than that of the industry base, the quotient was used. If the industry base figure was less than that of the company, the quotient was subtracted from 200 and the difference was used. The purpose of the latter procedure, according to the Robert Morris Associates, was to prevent distortion of the composite index as a result of the fact that while a company ratio in relation to the industry could not be smaller by more than 100 %, it could be larger to infinity unless some arbitrary limit were imposed. Values were found by multiplying relatives by weights. The index was the sum of the values.

(*c*) Amount of owners' capital invested in fixed assets.
(*d*) Merchandising policy, especially turnover of inventory.
(*e*) Credit policy as reflected by the collection of accounts.
(*f*) Valuation and effectiveness of fixed plant.
(*g*) Efficiency of owners' investment.
(*h*) Profit margin on sales.

Does this comparative study indicate that the Twing Packing Company was suffering from difficulties other than those common to the trade?

RICH ENGINE COMPANY

EXTENSION OF CREDIT TO A MANUFACTURER OF AUTOMOBILE ENGINES—EFFECT OF THE BUSINESS CYCLE[1]

In February, 1928, the Shelburne National Bank of Detroit learned that the Rich Engine Company was dissatisfied with its existing Detroit banking connection. The bank at once sent a representative to Toledo, where the company's plant was located, to ascertain the desirability of soliciting an account.

The company manufactured four-cylinder and six-cylinder gasoline motors for automobiles, trucks, and tractors. From the time of its organization, in 1911, until 1921, when the concern shut down, it had met with fair success. The operating owners sold a controlling interest in both the common and the 7½% cumulative preferred stock to an experienced manufacturer, Mr. Byers, and a group of his associates. Mr. Byers found it impossible to improve the capital structure of the company because of opposition from the minority preferred stockholders. By 1924, however, sufficient profit had been made to permit drastic write-offs of obsolete inventory and equipment and the elimination from the books of all past-due accounts. These extraordinary charges caused a large deficit in the balance sheet. At the same time a $1,000,000 issue of 10-year 6% serial first-mortgage bonds was brought out. Mr. Byers and the other officers purchased at par $400,000 of these securities, the company applying the proceeds to the reduction of trade indebtedness. The remaining $600,000 in bonds was exchanged with the company's creditor banks for part of the unpaid advances which the latter had made.

After these adjustments had been effected, the company made steady progress under Mr. Byers' management, as shown by the statements reproduced in Exhibit 1. Payments on funded debt were made prior to the due dates of the sinking fund requirements. By December 31, 1927, the company had retired $288,000 of the $600,000 in bonds which the banks had taken in 1924, whereas the indenture called for retirement of only $100,000 by that date.

[1] For reference readings on the business cycle, see the last page of this case; for data on business conditions, consult Appendix II and other sources.

Dividends on preferred stock were allowed to accumulate, and all earnings were applied to reducing the company's deficit. As a result, during the years 1925, 1926, and 1927 the balance sheet deficit was cut down from $1,152,314 to $514,760. Accumu-

EXHIBIT 1

Financial Statements of the Rich Engine Company, as of December 31, 1923 to 1927*

	1923	1924	1925	1926	1927
Assets					
Cash	$ 36,006	$ 66,266	$ 67,978	$ 72,774	$ 143,892
Notes and Accounts Receivable	277,631	150,117	272,363	261,108	298,568
Inventory	1,490,834	749,910	721,499	928,067	916,214
Current Assets	$1,804,471	$ 966,293	$1,061,840	$1,261,949	$1,358,674
Land, Buildings, and Equipment	2,334,129	2,088,084	2,191,512	2,289,818	2,430,335
Prepaid Items	110,883	5,125	3,820	5,262	14,201
Good will	325,000	325,000	325,000	325,000	325,000
Total Assets	$4,574,483	$3,384,502	$3,582,172	$3,882,029	$4,128,210
Liabilities					
Notes Payable—Banks	$ 997,200	$ 364,510	$ 286,510	$ 252,710	$ 237,250
Trade	304,820	93,505	119,293	148,613	87,945
Accounts Payable	284,464	129,465	137,829	223,106	242,140
Accruals and Provision for Taxes	236,436	76,072	78,815	80,526	142,362
Bonds Due Currently	....	......	....	5,000	65,000
Current Liabilities	$1,822,920	$ 663,552	$ 622,447	$ 709,955	$ 774,697
6% First-mortgage Bonds	....	1,000,000	962,000	897,000	712,000
Reserve for Depreciation	703,038	781,924	867,175	961,815	1,064,933
7½% Preferred Stock	990,700	990,700	990,700	990,700	990,700
Common Stock	1,038,840	1,100,640	1,100,640	1,100,640	1,100,640
Surplus	18,985	1,152,314(d)	960,790(d)	778,081(d)	514,760(d)
Total Liabilities	$4,574,483	$3,384,502	$3,582,172	$3,882,029	$4,128,210
Net Profits	$ 44,762	$ 85,596	$ 185,973	$ 182,711	$ 263,569
Extraordinary Charges to Surplus	....	1,296,044	....	....	....
Current Ratio	.98–1	1.45–1	1.70–1	1.77–1	1.75–1
Net Worth—Debt	.94–1	.36–1	.50–1	.61–1	.84–1
Net Worth—Fixed Assets	1.05–1	.47–1	.60–1	.74–1	.91–1
Merchandise—Receivables	5.36–1	4.99–1	2.64–1	3.55–1	3.06–1
Profit on Net Worth	2.59 %	13.94 %	23.08 %	18.48 %	21.05 %
Acid Test	.17–1	.32–1	.54–1	.47–1	.57–1

* Audited.
(d) Deficit.

lated preferred stock dividends on December 31, 1927, amounted to $52.50 a share, or slightly over $520,000, no payment having been made since the last quarter of 1920. The preferred stockholders did not object because Mr. Byers and his associates held over 76% of the outstanding shares. It would have required

$374,000, however, to retire at the call price of 105 and back dividends the 2,375 shares not controlled by the management. Since the minority holders refused to relinquish their stock on any other basis and were not threatening to petition for receivership, Mr. Byers was satisfied.

On his return from Toledo, the representative whom the bank had sent to interview the executives of the company reported that the concern would open an account with the bank in return for the extension of a $150,000 line of credit. He stated that the company's plant was in good condition and was well organized. The premises occupied, however, were small for the volume of business being done, but Mr. Byers had expressed his intention of erecting a new main building as soon as the deficit was eliminated from the company's balance sheet. The investigators also reported that accurate records were kept, manufacturing costs were relatively low, and expenditures were carefully watched. Executive salaries, however, appeared to be high. Mr. Byers drew $30,000 a year and, in addition, a bonus of 2% of the annual net profits. The vice president of the concern was paid $20,000 and received 1% of the net profits up to $150,000 and 2% of the net profits above that figure.

Inquiries among the trade disclosed the fact that Mr. Byers and his associates were regarded as honorable and capable men and that under their direction the company was expected to make continued progress. Rich engines were well regarded by automotive engineers in the Detroit area. The company purchased the heavy castings and electrical equipment used in its motors, but manufactured all other parts itself. Sales were made almost entirely to four customer companies. Two truck manufacturers and one maker of taxicabs used Rich engines exclusively, and a large tractor company powered all its smaller models with a specially constructed Rich motor. There seemed to be no danger that the Rich Engine Company would lose any of its important contracts, and concentration of sales through a few outlets simplified the control of production, inventory, and receivables. The tractor and taxicab companies were leaders in their respective fields, and the two truck manufacturers were competing successfully with the larger concerns in that business.

On the basis of this information and its personal contact with Mr. Byers, the bank agreed to lend the company $150,000 for six months at 5¼% interest. It was understood that the bank

would consider extending a definite line of credit if this first loan was satisfactorily handled and commensurate balances were maintained.

In September, 1928, the bank granted a $150,000 credit line to the company. The full amount of this line was in use during the entire year 1929, and the bank extended an additional loan of $150,000, at 5¾%, to help carry the company's peak inventory load during the spring and early summer. Deposit balances were in satisfactory proportion to loans,[1] and the account was not unduly active.

The years 1928 and 1929 were highly profitable for the company. The balance sheet deficit was entirely eliminated by June 30, 1929, and at that time the management started construction on a new factory building which it hoped to have completed by February, 1930. In the fall of 1929, however, automobile production and demand for the company's products fell off sharply. Sales volume during 1930 was greatly reduced, and operations for the year resulted in the first annual loss which the company had shown since 1922. The Rich Engine Company was confronted with the failure of the Morton Truck Corporation, one of its four large customers, which went into receivership during the fall, owing the company $41,500. Depressed agricultural conditions cut seriously into orders received from the customer tractor company. This concern was considered to be the Rich Engine Company's best single customer, and the inventory which appeared on the books of the Rich Engine Company on December 31, 1930, as shown in Exhibit 2, consisted largely of special-type tractor motors for which there was no market elsewhere. Finally, overhead expenses on the Rich Engine Company's new plant were heavy, and manufacturing operations were virtually at a standstill.

Loan—1929			Number of Months Out of Debt	Average Ledger Balance
High	Low	Average		
$300,000	$150,000	$221,000	0	$41,600

EXHIBIT 2

Financial Statements of the Rich Engine Company, as of December 31, 1929, and 1930*

	1929	1930
Assets		
Cash	$ 140,777	$ 21,811
Notes and Accounts Receivable	280,729	118,314
Inventory	1,039,311	834,807
Current Assets	$1,460,817	$ 974,932
Land, Buildings, and Equipment	3,065,160	3,263,426
Prepaid Items	68,009	75,903
Goodwill	325,000	325,000
Total Assets	$4,918,986	$4,639,261
Liabilities		
Notes Payable—Banks	$ 487,500	$ 430,000
Notes Payable—Trade	125,450	41,380
Accounts Payable	179,283	86,464
Accruals and Tax Provision	124,307	96,937
Bonds Due Currently	87,000	130,000
Current Liabilities	$1,003,540	$ 784,781
6% First-mortgage Bonds	539,000	409,000
Reserve for Depreciation	1,177,413	1,249,232
7½% Preferred Stock	990,700	990,700
Common Stock	1,100,640	1,135,490
Surplus	107,693	70,058
Total Liabilities	$4,918,986	$4,639,261
Net Profits	$ 231,040	$ 32,260(d)
Current Ratio	1.45–1	1.24–1
Net Worth—Debt	1.21–1	1.56–1
Net Worth—Fixed Assets	.99–1	.92–1
Merchandise—Receivables	3.70–1	7.05–1
Profit on Net Worth	12.32%	....
Acid Test	.42–1	.17–1

* Audited.
(d) Deficit.

Early in 1931 Mr. Byers and his associates in management instituted rigid economies throughout the organization. Executive salaries were cut, many employees were released, and the rate of depreciation charged on fixed assets was reduced. Current indebtedness was reduced as rapidly as possible. Careful attention was given to the collection of receivables; but, even so, nearly $31,000 of the $118,314 in notes and accounts shown on the December 31, 1930, balance sheet remained past due, and the auditors insisted that the company write off entirely the $41,500 debt of the Morton Truck Corporation. Attempts to

dispose of the different kinds of finished inventory on hand, even at prices below cost, were unsuccessful. In an effort to utilize at least a portion of plant capacity and to find a new sales outlet, the company undertook the manufacture of 2 h.p. and 3 h.p. air-cooled motors for use on lawn mowers, pumps, and spraying machines.

On December 31, 1930, the company owed $175,000 each to the Shelburne National Bank and one of its Toledo banks. A second local bank held $80,000 of the company's notes, and each of the two Toledo institutions had $65,000 in bonds which were due March 31, 1931. It was Mr. Byers' plan to retire the $130,000 in bonds on their due date. He believed that collections of current receivables and sales of small motors during the ensuing three months would make this possible, and promised personally to supply any deficiency in the sum required. He stated, however, that his personal guarantee would be worth little beyond this amount, since he had already taken up $9,000 in bonds from one of the Toledo banks and had purchased $34,850 par value of common stock to supply the company with cash. After retirement of the bonds due in March, 1931, the entire outstanding portion of the issue would be in the hands of the management. Mr. Byers, on behalf of the management, agreed to accept an indefinite extension of the maturities and a suspension of the interest, if necessary, if the banks would not force liquidation. He also pledged himself to reduce the bank debt as rapidly as possible from any funds which were not essential for working-capital purposes.

The creditor banks undertook a study of the inventory and fixed assets of the company in order to determine the possibility of satisfying their claims at once. The inventory situation appeared hopeless until such time as disposition could be made of finished tractor motors on hand. These motors constituted nearly 60% of the total book value of inventory on December 31, 1930. The remaining 40% was equally divided between finished engines and raw materials which were being used in the manufacture of the new small motors. There was virtually no market for factory properties in Toledo in the spring of 1931. The banks concluded that the company's real estate and plant would not sell for more than $750,000 at a forced sale. Furthermore, if liquidation was insisted upon, it was certain that the management would enforce its claim for $409,000 on the fixed assets of the

company. This would leave a maximum of $341,000 to satisfy the banks and the $224,781 of other current claims, provision having already been made for bonds due currently.

For the purpose of directing attention especially in this case to the effect of the business cycle[1] upon particular credit risks, prepare a brief résumé of the changes in general business conditions during the years 1920 to 1930, inclusive, and indicate specific effects of such changes in general business conditions upon the statements and ratios as tabulated in Exhibits 1 and 2.

Should a study of general business conditions constitute an integral part of the evidence considered in each credit analysis?

Does a period of prosperity increase or decrease the risks of bank credits?

When business drops off, should a banker begin reducing credit lines?

Appraise the management of the Rich Engine Company. Should an officer of the bank have objected to any of the policies instituted by the management? If so, to which policies, and why?

Specifically, should the Shelburne National Bank have made a loan of $150,000 to the Rich Engine Company in March, 1928? Should the loans of $300,000 have been approved in 1929?

What action should the three banks have taken after the receipt of the 1930 year-end statement?

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[1] Mitchell, W. C., *Business Cycles: The Problem and Its Setting*, Ch. II; Sprague, O. M. W., "Bank Management and the Business Cycle," *Harvard Business Review*, October, 1922, pp. 19–23; Slichter, S. H., *Modern Economic Society*, Ch. XX; von Haberler, Gottfried, *Prosperity and Depression;* Hansen, A. H., *Cycles of Prosperity and Depression.*

SAWYER ISLAND LUMBER COMPANY

EXTENSION OF CREDIT TO A LUMBER COMPANY—EFFECT OF CONDITION OF THE INDUSTRY[1]

The Sawyer Island Lumber Company operated logging camps and a mill in the Douglas fir region of the state of Washington. Since the time of its organization the company had been a customer of the Loggers' and Lumbermen's National Bank in Seattle, where it had a line of credit amounting to $250,000. For several years prior to 1929 this company had been suffering from conditions common to concerns in its field. Serious overcapacity and overproduction had coincided with a long period of low prices and with rising costs of logging and milling operations. Depletion of the most desirable and easily worked tracts of timber, cutthroat price competition from small loggers, rising costs of shipping lumber to the eastern markets, and burdensome taxation, also, had been almost universal difficulties in the industry.

Business relations between the Sawyer Island Lumber Company and the Loggers' and Lumbermen's National Bank had been satisfactory. The company's borrowings had not been excessive, ledger balances had been liberal,[2] and the activity of the account had been small.

The management of the Sawyer Island Lumber Company was highly respected, and for some time officials of the bank had held the belief that the company's record was satisfactory in view of the difficulties prevalent in the trade. However, by the middle

[1] See: Glover and Cornell, *The Development of American Industries;* Mead and Grodinsky, *The Ebb and Flow of Investment Values.* See case of Velie, Lowe & Company, Ebersole, J. F., *op. cit.*, first edition, pp. 55–59.

[2]

Year	Average Loan	Average Ledger Balance	Number of Months Out of Debt
1925	$ 25,000	$47,000	8
1926	113,000	57,000	0
1927	52,000	46,000	2
1928	68,000	40,000	6
1929	233,000	24,000	0

of February, 1930, the lumber situation, some of the aspects of which are shown in Exhibits 1 to 5, had become so acute that

EXHIBIT 1

Lumbering in the Pacific Northwest
Volume of Business and Capacity

"Since 1909 the total [annual] consumption of lumber in the United States has dropped off by one-fifth . . .

"A recent survey, made by the West Coast Lumbermen's Association, of 634 living sawmills in western Oregon and Washington, reveals an annual capacity for lumber production, conservatively estimated on normal operating equipment and operating schedules, of 13,344,000,000 board feet. This is immediately available manufacturing capacity; the maximum possible, or potential, capacity of these plants is much greater. The maximum volume of lumber sold in any one year by these mills was about 9,692,000,000 board feet.

"These figures indicate an excess of 28% in directly available capacity over the maximum volume of annual sales which the industry has yet been able to make."

—W. B. Greeley, Secretary-Manager, West Coast Lumbermen's Association, before the Society of American Foresters, December 30, 1929. Reprinted from the *Journal of Forestry,* February, 1930, pp. 192–193.

"Sawmills are reducing output to an extent unbelievable, yet it is doubtful if the present rate of curtailment will be sufficient to weather the storm [of overproduction]."

—R. W. Vinnedge, President of the Pacific Logging Congress, at that body's twentieth annual meeting. Reprinted from *The Timberman,* November, 1929, p. 37.

Table 1

Production—297 Identical Mills*

Actual Production, Week Ended February 8, 1930	178,177,762	feet
Average Weekly Production, 6 Weeks Ended February 8, 1930	137,194,566	"
Average Weekly Production during 1929	203,152,852	"
Average Weekly Production, last Three Years	210,933,628	"
Weekly Operating Capacity†	291,508,073	"

* West Coast Lumbermen's Association Weekly Report, *Commercial and Financial Chronicle,* February 22, 1930, p. 1189.

† Weekly operating capacity is based on averaged hourly production for the 12 last months preceding the mill check and the normal number of operating hours per week.

Table 2

Douglas Fir Production*
(Unit—1,000,000 board feet)

(The percentage of actual to normal production of reporting mills is applied to the normal production of a fixed number of mills.)

1919	4,479	1925	6,528
1920	4,565	1926	6,322
1921	3,573	1927	5,972
1922	5,283	1928	4,935
1923	6,104	1929	3,864
1924	5,866		

* Source: Standard Statistics Company, *Statistical Bulletin.*

the bank felt it impossible to maintain a passive attitude toward any concern in this line of business. Consequently, it

was decided to consider carefully the individual situation of each customer lumber company which did not submit an entirely

EXHIBIT 2

Lumbering in the Pacific Northwest

Prices

"Log and lumber prices are at the irreducible minimum below which recession cannot be made without dissipating capital assets."

—R. W. Vinnedge, President of the Pacific Logging Congress, at that body's twentieth annual meeting. Reprinted from *The Timberman*, November, 1929, p. 37.

Table 1

Douglas Fir Prices*

(Unit: average of one price weekly in dollars per 1,000 feet No. 1, common, surfaced one side, 1 × 8 and 10 inches, f.o.b. mill)

Month	1924	1925	1926	1927	1928	1929	1930
January	$18.80	$18.31	$15.50	$17.91	$14.75	$17.40	$17.34
February	18.88	18.50	15.88	17.19	15.72	18.19	......
March	18.75	17.81	16.50	17.32	16.45	18.78	......
April	17.90	18.00	17.00	17.16	16.56	19.00	......
May	17.19	17.80	16.56	17.13	16.85	18.75	......
June	16.19	16.88	16.30	17.73	16.94	18.81	......
July	16.20	16.70	16.87	16.69	17.19	18.63	......
August	15.94	16.75	16.74	16.70	17.77	18.53	......
September	17.06	17.00	16.56	16.91	17.63	18.22	......
October	16.80	16.50	17.53	16.75	18.09	17.78	......
November	15.88	16.17	16.91	15.34	18.16	17.50	......
December	17.30	15.55	17.00	15.63	17.63	17.60	......

* Source: Standard Statistics Company, *Statistical Bulletin*, and *February Supplement, 1931*. It is the consensus of opinion among lumbermen in northwestern Washington that a price of less than $18 per thousand feet means unprofitable operation.

EXHIBIT 3

Lumbering in the Pacific Northwest

Profits

"For a number of years the West Coast Association has compiled returns representing from 30 to 85 different sawmills showing the cost of producing lumber and the realization from its sale. These mills fairly represent the industry because they are well distributed as between the large and small operations and between the rail and cargo plants. For the 10 years from 1919 to 1928, inclusive, this record reveals four years in which the industry showed an average gain ranging from 77 cents per thousand board feet in 1922 to $2.93 per thousand feet in 1920. It reveals six years in which the industry operated at an average loss ranging from 18 cents in 1928 to $2.15 in 1921. The five years from 1924 to 1928, inclusive, were all 'loss' years for the average mill reporting to this compilation, and 1929 will undoubtedly fall in the same category."

—W. B. Greeley, Secretary-Manager, West Coast Lumbermen's Association, before the Society of American Foresters, December 30, 1929. Reprinted from the *Journal of Forestry*, February, 1930, p. 193.

satisfactory 1929 statement. It would be difficult to turn down requests for continued accommodation simply because of trade

conditions, but the bank was convinced that such a course would be necessary in those instances where it could not be absolutely certain of the safety of its loans for the year 1930.

When the bank received the 1929 statement of the Sawyer Island Lumber Company, shown in Exhibit 6, it requested the president of this company to furnish additional information on certain points, and obtained the following facts from him: (1) The 6½% bonds had a first lien on all plants and timberlands

EXHIBIT 4
Lumbering in the United States
Failures*

	1927	1928	1929
Number			
All Manufacturers in Tabulation	5,682	5,924	6,007
Lumber, Carpenters, and Coopers	850	969	1,135
Lumber, Etc., as Per Cent of All	14.9%	16.3%	18.8%
Amount of Liabilities (000 omitted)			
All Manufacturers in Tabulation	$211,505	$182,478	$186,734
Lumber, Carpenters, and Coopers	43,986	50,782	53,631
Lumber, Etc., as Per Cent of All	20.7%	27.8%	28.7%

Note.—Both in regard to number of failures and amount of liabilities involved, the item, Lumber, Carpenters, and Coopers, represents a larger percentage of the total in each year than *any other* of the 15 classifications included in this study, except Miscellaneous.

* Source: *Dun's Review*, January 11, 1930, p. 10.

EXHIBIT 5
Lumbering in the United States
Employment and Payrolls in Lumber and Lumber Products*
(Relatives, 1923 to 1925 = 100. Without seasonal adjustment)

Years	Employment	Payrolls
1919	93.2	89.2
1920	88.1	109.2
1921	74.5	68.0
1922	95.5	82.1
1923	100.9	100.0
1924	98.1	98.4
1925	101.0	101.6
1926	100.5	102.0
1927	92.3	95.1
1928	88.1	90.5
1929	88.2	90.5

* Source: Standard Statistics Company, *Statistical Bulletin*.

owned by the company. These assets would bring at forced sale their book value less the reserve for depreciation and depletion, or approximately $3,400,000. (2) The company was contingently liable for $325,916 of notes of subsidiaries maturing in approximately equal amounts each month to and including July, 1930. (3) The inventory of finished lumber was valued at the December, 1929, market price. Since then mill prices had dropped off 25 cents per thousand feet. (4) Investment in subsidiaries consisted of the common stock of three affiliated companies. Only one of these was making a profit, and, although the account had been written down in each of the last three years, the president was doubtful whether more than $500,000 could be realized from the sale of these assets. (5) All the receivables shown on the 1929 statement were apparently good, since they had been carefully analyzed by the company's auditors. Some 20%, however, might prove to be from one to three months slow. (6) The preferred stock was preferred as to assets as well as to dividends. The unpaid cumulative dividends on this stock amounted to $200,000.

The president stated that the company planned to dispose of its subsidiaries during 1930, but even so he believed that $800,000 of bank credit would be necessary to meet the year's peak requirement. At the time, the company had open lines totaling $750,000, and the president wished each of the three interested banks to increase to $300,000 the accommodation extended. In return for such an increase by the Loggers' and Lumbermen's National Bank, the company would promise 20% balances and would be willing to pay any reasonable amount of interest.

For the purpose of directing attention particularly in this case to the effect of the condition of the industry on credit risks:

(*a*) Should a careful study of the industry form a part of every credit analysis?

(*b*) Is an individual company, making an average showing in a depressed industry, apt to be a better or worse bank credit risk than an individual company making a poor showing in a prosperous industry?

(*c*) Would a bank ever be justified in discontinuing a line of credit granted to a well-managed concern, simply on the basis of trade conditions?

In view of conditions in the industry, the statement submitted on December 31, 1929, and the information furnished by its

EXHIBIT 6

Financial Statements of the Sawyer Island Lumber Company, as of December 31, 1925 to 1929*

	1925	1926	1927	1928	1929
Assets					
Cash	$ 254,005	$ 113,215	$ 99,313	$ 131,146	$ 85,318
Notes Receivable		68,159	147,443	124,489	
Accounts Receivable	1,264,295	956,323	843,565	748,281	892,852
Inventory (Finished Lumber)	2,261,706	1,823,631	1,221,202	1,497,069	1,495,956
Marketable Securities			6,500	2,400	
Cash Value Life Insurance Policies	31,046	36,674	43,172	48,067	56,779
Advances on Logging Operations and Contracts	56,507	17,949	11,383	10,211	20,362
Current Assets	$ 3,867,559	$ 3,015,951	$ 2,372,578	$2,561,663	$2,551,267
Plants and Timberlands	5,873,313	6,859,430	5,266,275	4,527,318	4,669,835
Deferred and Prepaid Items	316,123	278,646	235,707	192,540	228,975
Investment in Subsidiaries	91,799	676,143	986,745	861,988	672,518
Miscellaneous Accounts and Notes Receivable	23,276	11,199	27,929	21,271	12,253
Treasury Stock		100,000	1,130,000	1,129,200	1,129,200
Unused Plants and Timberlands					415,327
Total Assets	$10,172,070	$10,941,369	$10,019,234	$9,293,980	$9,679,375
Liabilities					
Notes Payable—Borrowed Money	$ 109,078	$ 100,473	$ 600,000		$ 639,650
Notes Receivable Discounted					100,647
Accounts Payable	269,095	229,442	153,879	$ 189,821	473,533
Deposits of Officers and Employees	7,369	10,000	830	10,245	474
Sundries and Accruals	203,184	211,583	168,292	165,707	190,594
Reserve for Taxes	30,941	44,917	54,831	54,831	37,242
Dividends Payable	40,833	39,667	33,483	27,659	27,659
Bank Loans on Purchase of Timberlands		800,000			
Bonds Due Currently	125,000	125,000	125,000	125,000	125,000

Current Liabilities	$ 785,500	$ 1,561,082	$ 1,136,315	$ 573,263	$1,594,799
6% Bonds	180,000				
6½% Bonds (1st Mortgage)	2,229,167	2,104,167	1,979,167	1,854,167	1,729,167
Deferred Credits	75,248	163,434			
Notes Payable—Due 1/17/33				25,000	25,000
Reserve for Depreciation and Depletion	1,476,745	1,509,077	1,396,635	1,465,025	1,680,441
Other Reserves		12,003	11,061	10,790	14,247
Minority Interest in Subsidiaries	3,000	199,892			
Preferred Stock (7%)	3,500,000	3,500,000	3,500,000	3,500,000	3,500,000
Common Stock	290,625	290,625	290,625	290,625	290,625
Earned Surplus	787,519	637,806	515,625	388,127	336,819(d)
Surplus by Appreciation (Capital)	844,266	963,283	1,189,806	1,186,983	1,181,915
Total Liabilities	$10,172,070	$10,941,369	$10,019,234	$9,293,980	$9,679,375
Contingent Liabilities	$ 285,388	$ 737,053	$ 872,651	$ 506,955	$ 376,466
Net Profits		$ 92,370	$ 328,504	$ 30,644(d)	$ 364,500(d)
Dividends Paid		242,083	231,817	165,982	165,956
Current Ratio	4.92–1	1.93–1	2.08–1	4.46–1	1.59–1
Net Worth—Debt	1.69–1	1.49–1	1.40–1	1.72–1	1.04–1
Net Worth—Fixed Assets	1.23–1	1.02–1	1.12–1	1.38–1	1.02–1
Merchandise—Receivables	1.78–1	1.78–1	1.23–1	1.71–1	1.67–1
Acid Test	1.93–1	.72–1	.95–1	1.75–1	.61–1
Profit on Net Worth		1.68%	7.52%		

* Audited.
(d) Deficit.

president, was the Sawyer Island Lumber Company entitled to a total of $900,000 of unsecured bank credit for the year 1930?

Should the Loggers' and Lumbermen's National Bank have increased, continued, decreased, or terminated the $250,000 credit line extended to this company in February, 1930?

Should marketable securities and cash value of life insurance policies be included in computing the ratios for the acid test?

From the point of view of the creditors of the Sawyer Island Lumber Company, particularly the interested banks, would liquidation have been desirable in 1930?

FOURTH OF JULY COMPANY

EXTENSION OF CREDIT TO A MANUFACTURER OF FIREWORKS—EFFECT OF SEASONAL VARIATION ON CREDIT RISK[1]

The Fourth of July Company, located in Minneapolis, Minnesota, manufactured and sold pyrotechnic materials for display purposes. During 1933 the bank which had financed the company's seasonal needs for working capital for several years became dissatisfied with the information available from the company's annual year-end balance sheets. The December figures always indicated a very liquid position, although it was the custom of the company to borrow heavily during the summer months. In January, 1934, the bank requested that monthly financial statements, as shown in Exhibit 1, be furnished the credit department, which was considering the company's credit line for the coming year.

Sales of the company, which were concentrated in the latter part of June and the first few days of July, were made to numerous small stores. The company manufactured heavily for stock during the spring, and borrowed from banks to finance both production and sales. Repayments were made during the late summer from the proceeds of the collection of accounts receivable. During the remainder of the year the company concentrated upon the collection of the remaining receivables, and carried on a minimum of manufacturing.

At the end of each year most of the receivables on the company's books were known as "carry-overs," that is, accounts secured by retailers' stocks of fireworks which were stored in the company's warehouse until the next selling season. The lack of change in the style of product from year to year, and the fact that it would not deteriorate if properly stored, made it certain that goods carried over would be in salable condition during the ensuing season.

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[1] See Kuznets, Simon, *Seasonal Variations in Industry and Trade*, Ch. I, pp. 248–259, 272–273, and Part 1 of Appendix I.

For ready reference a few indices of seasonal variation are reproduced in Appendix I, *infra*. These may be used where they apply to the cases in this book.

EXHIBIT I

Financial Statements of the Fourth of July Company, at the End of 1932, and Monthly in 1933

	12/31/32*	1/31/33	2/28/33	3/31/33	4/30/33	5/31/33	6/30/33	7/31/33	8/31/33	9/30/33	10/31/33	11/30/33	12/31/33*
Assets													
Cash	$ 2,821	$ 3,388	$ 2,589	$ 1,877	$ 1,810	$ 904	$ 4,148	$ 10,981	$ 10,719	$ 8,266	$ 12,931	$ 10,776	$ 6,974
Accounts Receivable, Net	8,388	6,878	7,964	8,189	8,869	10,017	8,324	21,534	18,988	22,968	13,457	13,264	4,841
Merchandise	40,236	41,553	41,504	42,530	50,356	55,164	69,074	49,543	48,131	46,139	48,788	49,704	56,138
Current Assets	$51,445	$51,819	$52,057	$52,596	$61,035	$66,085	$ 81,546	$ 82,058	$ 77,838	$ 77,373	$ 75,176	$ 73,744	$67,953
Capital Assets, Net	30,668	30,456	30,245	30,034	29,823	29,612	29,401	29,190	28,978	29,085	28,874	28,664	28,451
Prepaid Expenses, Etc.	4,761	3,502	3,245	2,987	2,656	2,332	2,258	2,182	2,183	1,421	1,585	1,073	823
Total Assets	$86,874	$85,777	$85,547	$85,617	$93,514	$98,029	$113,205	$113,430	$108,999	$107,879	$105,635	$103,481	$97,227
Liabilities													
Notes Payable					$ 7,500	$11,250	$ 24,109	$ 4,866	$ 6,710	$ 6,806			
Accounts Payable	$ 173	$ 330	$ 165	$ 472	636	740	1,035	742	391	295	$ 384	$ 161	$ 76
Deferred Expenses	217					180	285	542	69	326			
Current Liabilities	$ 390	$ 330	$ 165	$ 472	$ 8,136	$12,170	$ 25,429	$ 6,150	$ 7,170	$ 7,427	$ 384	$ 161	$ 76
Capital	60,000	60,000	60,000	60,000	60,000	60,000	60,000	60,000	60,000	60,000	60,000	60,000	60,000
Surplus	26,484	25,447	25,382	25,145	25,378	25,859	27,776	47,280	41,829	40,452	45,251	43,320	37,151
Total Liabilities	$86,874	$85,777	$85,547	$85,617	$93,514	$98,029	$113,205	$113,430	$108,999	$107,879	$105,635	$103,481	$97,227
Net Sales, Monthly		$ 938	$ 1,674	$ 1,231	$ 1,982	$ 2,788	$ 5,358	$ 58,858	$ 304	$ 5,984	$ 919†	$ 639	$ 8,058†
Sales, Year Ending	$77,128							‡					70,783
Profit, Year Ending	14,751(d)							‡					1,986(d)
Current Ratio	131.91	157.03	315.50	111.43	7.50	5.43	3.21	13.34	10.86	10.42	195.77	458.04	894.12
Net Worth—Debt	221.75	258.93	517.47	180.39	10.49	7.05	3.45	17.44	14.20	13.53	274.09	641.74	1,278.30
Net Worth—Fixed Assets	2.82	2.81	2.82	2.83	2.86	2.90	2.99	3.68	3.51	3.45	3.65	3.60	3.41
Merchandise Receivables	4.80	6.04	5.21	5.19	5.68	5.51	8.30	2.30	2.53	2.01	3.63	3.75	11.60
Collection Period§	40 days	33 days	38 days	39 days	42 days	47 days	39 days	102 days	90 days	109 days	64 days	63 days	25 days
Sales—Merchandise§	1.92	1.86	1.86	1.81	1.53	1.40	1.12	1.56	1.60	1.67	1.58	1.55	1.26
Sales—Net Worth§	.89	.90	.90	.91	.90	.90	.88	.72	.76	.77	.73	.75	.73
Sales—Fixed Assets§	2.52	2.53	2.55	2.57	2.59	2.60	2.62	2.64	2.66	2.65	2.67	2.69	2.49
Acid Test	28.74	31.11	63.96	21.33	1.31	.90	.49	5.29	4.14	4.21	68.72	149.32	155.46

* Audited.

† Excess of returns and allowances over gross sales for the month.

‡ For seven months ending July 31, 1933: sales, $72,833; net profit, $20,706.

§ In order to obtain comparable figures for these ratios, the amount of sales for the year ending December 31, 1932, was used for each statement up to the one dated December 31, 1933. Such a procedure is subject to some error, but is accurate enough in cases where annual sales do not fluctuate greatly.

(d) Deficit.

The company had little difficulty in maintaining its outlets against competition, but had found it necessary to cut prices in order to avoid too great a drop in the volume of its sales during the depression. As a result, operations were unprofitable in 1932 and 1933.

For the purpose of directing attention particularly in this case to the effect of seasonality upon banking risks:

(*a*) Analyze the changes shown in the statements in Exhibit 1 and determine which are due to seasonal factors and which to other causes.

(*b*) Did the annual statements furnish enough information to the bank for satisfactory credit analysis?

(*c*) What additional information was obtained by having the monthly statements?

(*d*) Under what circumstances should banks insist upon statements more frequently than once a year?

(*e*) If statements are received annually, should a bank request them as of any particular date?

HAYDEN AND STAUM, RECEIVERS, v. THE CITIZENS' NATIONAL BANK OF BALTIMORE[1]

120 Md. 163; 87 Atl. 672; 46 L.R.A. (NS) 1059n (1913)

RIGHT OF BANK TO SET-OFF—APPLYING DEPOSIT BALANCE TO NOTES NOT DUE[2]

STOCKBRIDGE, J. . . .[3] In June, 1909, a certificate of incorporation was executed by three persons as incorporators for the purpose of the conduct of a fruit and produce commission business under the name of "J. H. Seward and Company, Incorporated." . . .

The corporate entity so created began business in the month of June, 1909, and continued for eighteen months . . . A receiver [Hayden and Staum] was appointed on the 6th day of January, 1911 . . .

At the time of the appointment of the receiver there stood to the credit of J. H. Seward & Company, Incorporated, on the books of the Citizens' National Bank, the sum of $21,250.51. At the same time the bank was the holder of the four following promissory notes of the corporation, which it had discounted; one for $9,200, due January 6, 1911; one for $2,300, due January 19, 1911; one for $3,000, due March 14, 1911; and one for $4,500, due April 12, 1911; in all, $19,000 . . . On January 6, 1911, the date of the appointment of the receiver, and of the maturity of the note for $9,200, the same not having been paid, the bank charged it as a debit against the amount of the deposit standing to the credit of the corporation, and on the day following it in like manner debited the remaining notes which it held of the Seward Company. It claimed the right to do this under what is known as the Banker's lien, and the present bill seeks to set aside

[1] This case, and other legal decisions appearing in this case book, are offered merely as illustrations of significant legal problems which arise and affect decisions made in bank management. They are presented without any claim of legal finality.

[2] For an excellent and comprehensive survey of reasoning basic to decisions regarding set-offs, consult Moore and Sussman, "The Current Account and Set-Offs between an Insolvent Bank and Its Customer," *Yale Law Journal*, XLI, June, 1932, pp. 1109–1133.

[3] Portions of this case have been omitted.

this setting off of $19,000 against the deposit of $21,000, as being an attempt to create an unlawful preference in favor of the bank . . . The bill alleges a fraudulent collusion between the corporation and the bank, in that the bank had knowledge of the financial condition of Seward & Company and that the $21,000 of credit had been accumulated there for the purpose of carrying out the scheme of unlawful preference to the bank and release the liability of the endorser . . .

In considering the question of the right of the bank to assert a lien for the benefit of notes of a customer which it has discounted, but which are not yet due, there has been some diversity of decision in this country, and in such states as New York (Jordan v. Bank, 74 N. Y. 467), Missouri (Kortjohn v. Bank, 63 Mo. Ap. 166), South Carolina (Bank v. Mahon, 59 S.E. 31), Illinois (Bank v. Proctor, 98 Ill. 558) Wisconsin (Oatman v. Bank, 77 Wis. 501), and Michigan (Bradley v. Smith's Sons, 98 Mich. 449), it is held that in order that the bank may assert the lien and maintain the set-off, the debt must be due. In Wisconsin there is an express statute to that effect, and in Michigan a substantially similar statute. In New York the decisions, while asserting the broad, general proposition, qualify it in two ways: first, that if the note is a demand note it may be set off against the deposit of a customer under the lien (People v. St. Nicholas Bank, 44 App. Div. 313), and, second, in the leading case of Jordan v. Bank, *supra*, it is expressly stated that the "insolvency of a party sometimes moves equity to grant a set-off which would not be allowed at law."[1] In other states the right of set-off is distinctly recognized as existing in favor of a bank whether the note be due or not. Ky. Flour Co. v. Bank, 90 Ky. 225; Nashville Trust Co. v. Bank, 91 Tenn. 336; Georgia Seed Co. v. Talmadge, 96 Ga. 254; Skunk v. Bank, 16 Weekly Law Bulletin, 353, where the Ohio Court held that when a depositor becomes insolvent the bank holding notes not due which it had discounted for him and the proceeds of which had gone into his deposit account, the bank could, as against the insolvent or his assignee, withhold enough of the deposit to protect such notes. Stewart v. Bank, 6 Wkly. Notes of Cases (Pa.) 399, in which the Pennsylvania Court sustained the right of lien upon the ground that the establishment of insolvency operated to mature all debts. Ainsworth v. Bank,

[1] Equitable relief is granted on the basis of the existence of mutual credits.

119 Cal. 470; Demmon v. Bank, 5 Cush. 194; and Thomas v. Bank, 99 Iowa, 202. The doctrine announced in these cases has likewise received the approval of the Supreme Court of the United States in Schuler v. Israel, 120 U. S. 506 . . . The view in this state has been consistently in accord with the line of cases last cited; F. & M. Bank v. Franklin Bank, 31 Md. 404; Miller v. Bank, 30 Md. 392; Colton v. Drover's Building Asso., 90 Md. 85, in which case the note involved matured after the insolvency of the bank and the appointment of the receivers; Richardson v. Anderson, 109 Md. 641, in which case the authorities both here and elsewhere were fully and ably reviewed by Judge Thomas; and Bank v. Kenney, 116 Md. 24.

In view of these repeated decisions the rule of law in this state is too firmly established to be lightly shaken, and the decision of the court below must be affirmed, unless the evidence discloses some fraud on the part of the bank, or such facts properly brought to the knowledge and attention of the bank as to properly charge them with knowledge, which would make the acts done tantamount to a fraud. There are quite a number of these which were strenuously insisted upon by the appellant as being sufficient to justify such a finding, but upon a careful and exhaustive examination of each and every one of these the evidence given falls far short of what is required to justify a finding of collusion and fraud . . .

To what extent should bank officials depend upon their own knowledge in determining action involving legal problems?

To the extent that the right of set-off exists, what weight should it have in determining whether or not to make a loan?

NEW YORK COUNTY NATIONAL BANK v. MASSEY

192 U. S. 138; 24 Sup. Ct. 199 (1904)

RIGHT OF BANK TO SET-OFF—RECEIVING DEPOSITS RELATIVE TO THE CREATION OF A PREFERENCE IN BANKRUPTCY

Mr. Justice DAY . . . [1] The circuit court of appeals made the following findings of fact:

For a number of years past the bankrupts, George H. Stege and Frederick H. Stege, were engaged, in the city and county of New York, in the business of dealing in butter, eggs, etc., at wholesale, under the firm name and style of Stege & Brother. On January 27, 1900, they filed a voluntary petition of bankruptcy in the district court, with liabilities of $67,232.49 and assets of $20,729.66, and upon the same day were duly adjudicated bankrupts . . .

On January 23, 1900, in the morning, the bankrupts went to the New York County National Bank and asked the officers to have the two notes of $10,000 each, which fell due on January 26, extended. The bankrupts at that time informed the bank officers that they were unable to pay the notes then about to fall due. In the afternoon of the same day, January 23, 1900, the bankrupts again called upon the bank officers, and at that time they delivered to them a statement of their assets and liabilities, which statement was not delivered until after the deposit of $3,884.47 had been made on that day. This statement as of January 22, 1900, showed their assets to be $19,095.67 and their liabilities $65,864.61.

The bankrupts had kept their bank account in the New York County National Bank since May 6, 1899. On January 22, 1900, their balance in the bank was $218.50. On the same day they deposited in that account $536.83; on January 23, 1900, $3,884.47; on January 25, 1900, $1,803.95, making a total of $6,225.25 deposited in the three days mentioned. Of this amount there was left in the bank account on the day of the adjudication in bankruptcy, January 27, 1900, the sum of $6,209.25, the bank having honored a check of Stege Brothers after the date of all these deposits.

At the first meeting of creditors, February 9, 1900, the New York County National Bank filed its claim for $33,790.25.

In its proof of claim the bank credited upon one of the notes which became due on January 26, 1900, the deposit of $6,209.25. The claim was allowed by the referee in the sum of $33,750.25, being $40,000 less the amount on deposit in bank ($6,209.25), and a small rebate of interest

[1] Portions of this case are omitted.

on the unmatured notes . . . The District Judge on the 25th day of November, 1901, made an order affirming the order of the referee. From that order an appeal was duly taken by the trustee to the Circuit Court of Appeals. The deposits were made in the usual course of business; at the time they were made Stege Brothers were insolvent.

As a conclusion of law, the Court of Appeals held that the deposit would amount to a transfer enabling the bank to obtain a greater percentage of the debt due to it than other creditors of the same class, and that allowance of the claim should be refused unless the preference was surrendered. This case requires an examination of certain provisions of the bankrupt law . . .

. . . It cannot be doubted that, except under special circumstances, or where there is a statute to the contrary, a deposit of money upon general account with a bank creates the relation of debtor and creditor. The money deposited becomes a part of the general fund of the bank, to be dealt with by it as other moneys, to be lent to customers, and parted with at the will of the bank, and the right of the depositor is to have this debt repaid in whole or in part by honoring checks drawn against the deposits. It creates an ordinary debt, not a privilege or right of a fiduciary character . . . It is true that the findings of fact in this case establish that at the time these deposits were made the assets of the depositors were considerably less than their liabilities, and that they were insolvent, but there is nothing in the findings to show that the deposit created other than the ordinary relation between the bank and its depositor. The check of the depositor was honored after this deposit was made, and for aught that appears Stege Brothers might have required the amount of the entire account without objection from the bank, notwithstanding their financial condition . . . [1]

The law requires the surrender of such preferences given to the creditor within the time limited in the act before he can prove his claim. These transfers of property, amounting to preferences, contemplate the parting with the bankrupt's property for the benefit of the creditor and the consequent diminution of the bankrupt's estate. It is such transactions, operating to defeat the purposes of the act, which under its terms are preferences.

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[1] The mutual accounts between a bankrupt and his bank of deposit are closed by operation of law at the time the petition in bankruptcy is filed. *Cf.* In re Michaelis & Lindeman, Dist. Ct., S. D. N. Y. (1912), 196 *Fed. Rep.* 718.

As we have seen, a deposit of money to one's credit in a bank does not operate to diminish the estate of the depositor, for when he parts with the money he creates at the same time, on the part of the bank, an obligation to pay the amount of the deposit as soon as the depositor may see fit to draw a check against it. It is not a transfer of property as a payment, pledge, mortgage, gift or security . . . There is nothing in the findings to show fraud or collusion between the bankrupt and the bank with a view to create a preferential transfer of the bankrupt's property to the bank, and in the absence of such showing we cannot regard the deposit as having other effect than to create a debt to the bankrupt and not a diminution of his estate.

In our opinion the referee and the District Court were right in holding that the amount of the deposit could be set off against the claim of the bank, allowing it to prove for the balance . . .

Mr. Justice McKenna dissents.

What provisions of the bankrupt law[1] are involved in this case?

Wherein does the decision in this case differ from that in Scott v. Armstrong?[2]

Is it good public policy for banks to have the legal right of set-off?

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[1] For a copy of the Federal Bankruptcy Act, see Black, H. C., *Handbook of the Law and Practice in Bankruptcy*, Appendix, pp. 759–791. For a discussion of the point at issue, see *ibid.*, Sec. 160, pp. 385–387.

[2] 146 U. S. 499; 13 Sup. Ct. 148; or see Ebersole, J. F., *op. cit.*, first edition, pp. 50–51.

TURNER & SELLERS, INCORPORATED

ANALYSIS OF THE ACCOUNT OF A DEPARTMENT STORE[1]

Turner & Sellers, Incorporated, a well-managed and profitable department store, located in a city with a population of 80,000 near the middle western metropolis of Colton, had a banking connection with the Union National Bank of Colton. The Union National Bank granted this company a line of credit of $100,000, handled its payroll account, and occasionally received time deposits from it.

Although Turner & Sellers, Incorporated, was a fairly consistent borrower, it seldom used more than half its line except during the fall months and always cleaned up its loans for at least two weeks out of every year. Ledger balances were more than commensurate with loans, and the bank paid no interest while the store was in its debt, although 2% was paid on net balances at other times.

Upon receipt of the December 31, 1929, statement, herein shown as Exhibit 1, the Union National Bank decided that a special analysis should be made in order to determine whether the account was profitable. This decision was prompted by a consideration of the following factors: (1) the unusually large float[2] of uncollected checks which Turner & Sellers, Incorporated,

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[1] For valuable data on net gain and stock turnover of department and specialty stores of different sizes during the years 1921 to 1930, inclusive, see Harvard University, Bureau of Business Research, *Bulletins Nos. 33, 37, 44, 53, 57, 63, 74, 78, 83*, and especially *No. 85*, entitled *Operating Results of Department and Specialty Stores.*

[2] In calculating the balances kept by customers, a bank gives credit for checks deposited with it as soon as these checks are received. However, when out-of-town checks are deposited, a period of from one to eight days elapses between the time of deposit and the receipt of the cash equivalent by the bank crediting the depositor's account. These outstanding checks are referred to as "float."

The ledger balances which appear on a bank's records include this float, and because of this inclusion they fail to give an accurate picture of the value of a particular deposit account to the bank. The banker is interested in the loanable balance which is available for his use, that is, the *ledger balance* less the float of uncollected checks and the required reserves computed on the ledger balance. Consequently, when a customer's account shows a particularly large float, it is customary to make a special analysis to determine the amount of the actual collected or *net balance.*

In connection with the subject of ledger and net balances, the question arises as to which figure should be used by a bank in setting its deposit requirements and as a basis for paying interest on balances. It is held by some that a bank should not expect a 20% net balance against borrowings, and that a 20% ledger balance provides

EXHIBIT 1

Financial Statements of Turner & Sellers, Incorporated, as of December 31, 1925 to 1929*

	1925	1926	1927	1928	1929
Assets					
Cash	$ 6,220	$ 82,512	$ 29,338	$ 27,231	$ 30,766
Notes Receivable	31,206	13,121	41,872	....	....
Accounts Receivable	314,189	340,456	369,148	462,249	463,140
Merchandise	710,245	668,329	640,415	674,268	640,697
Current Assets	$1,061,860	$1,104,418	$1,080,773	$1,163,748	$1,134,603
Land, Buildings, and Equipment	772,400	709,157	690,106	670,129	668,074
Furniture and Fixtures	142,679	128,623	113,200	103,675	99,331
Investments	118,165	128,454	148,990	145,069	145,283
Miscellaneous Notes and Accounts Receivable	....	21,918	23,976	44,316	47,637
Other Assets	....	53,706	55,320	33,211	17,412
Total Assets	$2,095,104	$2,146,276	$2,112,365	$2,160,148	$2,112,340
Liabilities					
Notes Payable—Banks	....	....	....	....	$ 28,500
Accounts Payable	$ 31,356	$ 70,661	$ 71,206	$ 78,546	86,475
Due Officers and Employees	157,806	145,777	74,390	112,375	115,535
Reserve for Taxes	33,570	33,000	36,600	30,824	30,906
Sundries and Accruals	....	42,524	44,157	33,972	28,631
Bonds Due Currently	....	72,000	66,000	63,600	68,640
Current Liabilities	$ 222,732	$ 363,962	$ 292,353	$ 319,317	$ 358,687
Mortgage Bonds	360,000	216,000	141,600	68,880	....
Reserve for Contingencies	53,534	61,295	67,784	74,388	76,892
Common Stock	420,000	1,260,000	1,260,000	1,260,000	1,200,000
Surplus	1,038,838	245,019	350,628	437,563	476,761
Total Liabilities	$2,095,104	$2,146,276	$2,112,365	$2,160,148	$2,112,340
Net Sales	$2,751,958	$2,964,245	$2,966,286	$3,084,061	....
Net Profits	81,895	205,024	231,589	218,593	....
Current Ratio	4.76–1	3.03–1	3.69–1	3.64–1	3.16–1
Net Worth—Debt	2.50–1	2.59–1	3.71–1	4.37–1	4.67–1
Net Worth—Fixed Assets	1.59–1	1.79–1	2.00–1	2.19–1	2.18–1
Merchandise—Receivables	2.05–1	1.89–1	1.55–1	1.45–1	1.38–1
Collection Period	45 days	43 days	50 days	54 days	....
Sales—Merchandise	3.87–1	4.43–1	4.63–1	4.57–1	....
Sales—Fixed Assets	3.00–1	3.53–1	3.69–1	3.98–1	....
Sales—Net Worth	1.88–1	1.96–1	1.84–1	1.81–1	....
Acid Test	1.57–1	1.19–1	1.50–1	1.53–1	1.37–1
Profit on Sales	2.97 %	6.91 %	7.80 %	7.08 %	....
Profit on Net Worth	5.61 %	13.62 %	14.37 %	12.87 %	....

* Audited.

on the average for a float of from 10% to 15%, leaving as great an amount of free funds at the banker's disposal as can reasonably be expected. It is probably true that in many instances where reference is made to the balances to be kept against borrowings, it is intended that these balances should consist substantially of loanable funds. The extent to which banks succeed in obtaining such balances varies widely, principally because of competition and the possibility of losing accounts if requirements are rigidly observed. A bank will frequently remind its customers that they are not living up to their agreement if balances fall below a 20% stipulation, but usually it will not take drastic action because of low balances unless the account is not a profitable one.

In regard to the figure that a bank uses in computing the interest which it pays on deposits, it would obviously be unprofitable to pay interest on money which the bank does not have available. Consequently, when interest is paid, it should be computed on the net balance. Account analysis is treated more thoroughly in the cases of Warren National Bank, (A) and (B), *infra*.

Consult: Willis and Edwards, *Banking and Business*, revised edition, pp. 91–93; Lincoln, E. E., *Applied Business Finance*, fourth edition, pp. 406–410.

EXHIBIT 2

Account Analysis of Turner & Sellers, Incorporated, Monthly, 1928 and 1929

	Average Loan	Interest Collected on Loan at 6%	Number of Items	Activity Cost at 2 Cents per Item*	Net Revenue	Average Ledger Balance	Average Uncollected Balance	Average Reserve Required Against Ledger Balance§	Average Net Loanable Funds	Average Actual Amount Loaned	Net Revenue to Actual Amount Loaned	Commercial Paper Rate
1928												
January	$ 25,000.00	$ 125.00	1,063	$ 21.26	$ 103.74	$ 28,600.00	$ 19,300.00	$ 2,860.00	$ 6,440.00	$ 18,560.00	6.70%	3.88%
February	25,000.00	125.00	1,242	24.84	99.83†	40,800.00	40,900.00	4,080.00	4,180.00(d)	29,180.00	4.10	4.00
March	50,000.00	250.00	1,671	33.42	216.58	27,200.00	26,800.00	2,720.00	2,320.00(d)	52,320.00	4.96	4.15
April	25,000.00	125.00	1,240	24.80	100.20	21,100.00	15,500.00	2,110.00	3,490.00	21,510.00	5.58	4.40
May	50,000.00	250.00	1,179	23.58	226.42	17,100.00	11,000.00	1,710.00	4,390.00	45,610.00	5.95	4.55
June	25,000.00	125.00	1,103	22.06	102.94	32,500.00	30,700.00	3,250.00	1,450.00(d)	26,450.00	4.67	4.70
July	....	....	976	19.52	30.52‡	29,200.00	22,600.00	2,920.00	3,680.00	....	......	5.13
August	25,000.00	125.00	1,288	25.76	99.24	20,700.00	16,300.00	2,070.00	2,330.00	22,670.00	5.25	5.39
September	80,000.00	400.00	1,667	33.34	366.66	30,400.00	25,600.00	3,040.00	1,760.00	78,240.00	5.62	5.59
October	90,000.00	450.00	1,429	28.58	421.42	28,400.00	27,100.00	2,840.00	1,540.00(d)	91,540.00	5.52	5.50
November	90,000.00	450.00	1,771	35.42	414.58	34,100.00	29,000.00	3,410.00	1,690.00	88,310.00	5.63	5.38
December	65,000.00	325.00	1,983	39.66	285.34	31,100.00	23,200.00	3,110.00	4,790.00	60,210.00	5.68	5.43
Total	$550,000.00	$2,750.00	16,612	$332.24	$2,406.43	$341,200.00	$288,000.00	$34,120.00	$19,080.00	$534,600.00	5.40%‖	4.84%‖
1929												
January	$ 25,000.00	$ 125.00	1,217	$ 24.34	$ 100.66	$ 18,200.00	$ 14,200.00	$ 1,820.00	$ 2,180.00	$ 22,820.00	5.29%	5.50%
February	25,000.00	125.00	1,291	25.82	99.18	27,600.00	24,300.00	2,760.00	540.00	24,460.00	4.86	5.56
March	50,000.00	250.00	1,595	31.90	218.10	21,900.00	20,600.00	2,190.00	890.00(d)	50,890.00	5.14	5.69
April	75,000.00	375.00	1,100	22.00	353.00	20,900.00	20,400.00	2,090.00	1,590.00(d)	76,590.00	5.53	5.90
May	75,000.00	375.00	1,161	23.22	351.78	19,400.00	9,700.00	1,940.00	7,760.00	67,240.00	6.27	6.00
June	25,000.00	125.00	1,279	25.58	99.42	13,700.00	8,200.00	1,370.00	4,130.00	20,870.00	5.71	6.00
July	65,000.00	325.00	1,109	22.18	302.82	24,200.00	20,000.00	2,420.00	1,780.00	63,220.00	5.74	6.00
August	90,000.00	450.00	1,337	26.74	423.26	20,100.00	14,600.00	2,010.00	3,490.00	86,510.00	5.87	6.09
September	100,000.00	500.00	1,740	34.80	465.20	19,500.00	18,500.00	1,950.00	950.00(d)	100,950.00	5.52	6.13
October	100,000.00	500.00	1,397	27.94	472.06	18,400.00	18,100.00	1,840.00	1,540.00(d)	101,540.00	5.57	6.13
November	100,000.00	500.00	1,388	27.76	472.24	22,900.00	19,100.00	2,290.00	1,510.00	98,490.00	5.75	5.41
December	80,000.00	400.00	1,604	32.08	367.92	31,000.00	22,900.00	3,100.00	5,000.00	75,000.00	5.88	5.00
Total	$810,000.00	$4,050.00	16,218	$324.36	$3,725.64	$257,800.00	$210,600.00	$25,780.00	$21,420.00	$788,580.00	5.66%‖	5.78%‖

* The figure used by the Union National Bank as representing the average cost of handling an item was not based on a careful analysis. The bank, however, considered 2 cents per item to be a satisfactory approximation of this cost. In most cases the following costs, as given in American Bankers Association, *Commercial Bank Management Booklet No. 2, Profit and Loss Operations*, represent a fair general average:

Checks "on us" .... 3¼ cents
Clearings .... 1¼ "
Transit checks .... 1¾ "

† After allowing for 33 cents interest on overdraft.
‡ Expense after allowing for $11 interest paid on average July net balance at 2%.
§ Since Colton is a reserve city, the reserve requirement against demand deposits is 10%.
‖ Does not include cost of making and collecting loans.
(d) Deficit.

always had outstanding and the consequent reduction of net loanable balances; (2) the great activity of the account, which resulted in large expense for handling items; and (3) the considerable incidental expense involved in such things as wrapping and delivering the large amounts of small change handled for the store each day.

Accordingly, a monthly record of some of the important aspects of the account was prepared for the years 1928 and 1929, as shown in Exhibit 2.

The Union National Bank concluded from this analysis that under the existing circumstances the account was not a particularly desirable one. At the same time, the bank hesitated to approach Turner & Sellers, Incorporated, with any suggestions for the future lest it lose the goodwill and patronage of this company.

Viewed solely as a credit risk, what should be said as to the desirability of this account? Is an annual "clean up" for a period of two weeks customary or unusual, favorable or unfavorable?

Describe and criticize the method used for determining net revenue and percentage of net revenue to actual amount loaned.

What were the percentages of average ledger balances to maximum loans in 1928 and 1929? And of average net loanable funds to average loans? Would the requirement of an average ledger balance equal to 20% of the maximum loan be "reasonable" for this account?

Contrast this customers' loan with commercial paper as to (*a*) handling expense, and (*b*) yield.

Was this account a profitable one for the bank?

What action should the bank have taken regarding this account?

BECK & BENDER, INCORPORATED

THE EFFECT OF SECTION 5200 UPON LENDING DECISIONS

Beck & Bender, Incorporated, of Peabody, Massachusetts, was a long-established manufacturer of upper calf leathers for use in high-quality shoes. In February, 1931, Mr. Shortridge of the Second National Bank of Lynn solicited the business of Beck & Bender, Incorporated, which up to that time had not borrowed from any banks in Lynn. After some weeks Mr. Shortridge was successful in obtaining the company's promise to open a $50,000 line of credit at the Second National Bank, subject to the final approval of the bank's credit committee.

At the next meeting of the credit committee, Mr. Shortridge recommended that this line be approved. He stated that, although the profits of Beck & Bender, Incorporated, were in part dependent on leather prices and had been adversely affected in 1928 and 1930 by price declines which took place during those years,[1] the company had been able to eliminate inventory losses caused by style changes. Instead of finishing leather prior to the receipt of orders, hides were merely put through the tanning process and held "in the crust." Then, when orders had been received, the leather was finished according to the customer's specifications. Furthermore, all the customers, shoe manufacturers to whom the product was sold by the company's own salesmen, were reputable concerns whose connections with Beck & Bender, Incorporated, were firmly established. In view of these advantages enjoyed by the company and the satisfactory position indicated by its statements shown in Exhibit 1, Mr. Shortridge believed that it was a new business prospect of great promise.

The president of the Second National Bank agreed that the company appeared to be a good risk. He objected to granting the proposed credit, however, unless the bank was convinced that this account would prove to be a particularly desirable one. He pointed out the following considerations which had led him to this conclusion: (1) the $50,000 line which had been requested

[1] For chrome calf leather prices, see Standard Statistics Company, *Statistical Bulletin*, and *February Supplement, 1931*.

EXHIBIT 1

Financial Statements of Beck & Bender, Incorporated, as of December 31, 1925 to 1929*

	1925	1926	1927	1928	1929	1930
Assets						
Cash	$ 146,882	$ 68,282	$ 32,817	$ 36,480	$ 34,847	$ 35,725
Accounts Receivable	174,468	190,658	258,492	200,744	374,738	309,097
Merchandise	1,423,832	1,379,723	1,390,622	1,219,510	1,453,220	1,505,428
U. S. Government Securities	....	....	80,000	60,000	95,950	250,643
Current Assets	$1,745,182	$1,638,663	$1,761,931	$1,516,734	$1,958,755	$2,100,893
Machinery, Furniture, and Fixtures	272,581	274,780	273,573	271,808	265,888	270,471
Investments	170,291	165,492	163,992	154,991	161,592	21,392
Total Assets	$2,188,054	$2,078,935	$2,199,496	$1,943,533	$2,386,235	$2,392,756
Liabilities						
Notes Payable—Banks	$ 725,733	$ 480,000	$ 686,721	$ 531,721	$ 936,689	$1,041,689
Notes Payable	....	117,233	....	....	....	....
Accounts Payable	9,312	12,548	12,944	6,446	11,604	8,626
Current Liabilities	$ 735,045	$ 609,781	$ 699,665	$ 538,167	$ 948,293	$1,050,315
7% Preferred Stock	....	....	500,000	500,000	500,000	500,000
Common Stock	1,000,000	1,000,000	500,000	500,000	500,000	500,000
Surplus	453,009	469,154	499,831	405,366	437,942	342,441
Total Liabilities	$2,188,054	$2,078,935	$2,199,496	$1,943,533	$2,386,235	$2,392,756
Net Profits	$ 35,125	$ 51,444	$ 65,676	$ 4,465(d)	$ 60,102	....
Dividends Paid	35,000	35,000	35,000	35,000	35,000	$ 35,000
Current Ratio	2.37–1	2.68–1	2.51–1	2.81–1	2.06–1	2.00–1
Net Worth—Debt	1.97–1	2.40–1	2.14–1	2.61–1	1.51–1	1.27–1
Net Worth—Fixed Assets	5.33–1	5.34–1	5.48–1	5.17–1	5.40–1	4.96–1
Merchandise—Receivables	8.16–1	7.23–1	5.37–1	6.07–1	3.87–1	4.87–1
Profit on Net Worth	2.41 %	3.50 %	4.37 %	....	4.17 %	....
Acid Test	.43–1	.42–1	.41–1	.44–1	.43–1	.32–1

* Not audited, but signed by president.
(d) Deficit.

was the legal limit which the capital and surplus of the Second National Bank allowed it to lend to one customer;[1] (2) the bank already had a large proportion of its loans in the shoe and leather industry, and in the past had sustained more losses on these accounts than on those of any other group of customers; (3) Beck & Bender, Incorporated, although promising 20% balances while borrowing, had requested payment of 1½% interest on these balances, and had indicated that it would consider 4½% a maximum rate to pay on loans in view of the easy money conditions prevailing in the New York and Boston markets at that time.[2]

Should bankers refuse all loans requested on unaudited statements or without sales figures? Evaluate the probable accuracy of "audited" as compared with "unaudited" statements when furnished for credit-granting purposes. Are all "audited" statements equal in their approach to accuracy?

Should the standards for judging credit risks be higher or lower for prospective customers than for actual customers?

Should business concerns have lines of credit at more than one bank?

How much strength is added to the financial statements by the holdings shown of United States Government bonds?

Is the treasurer of this company thrifty or careless in handling current funds?

What are the prospects for growth in size and value of this account?

Were the objections, which the president of the Second National Bank advanced against making this loan, valid?

What contribution, if any, is made to better bank management by Section 5200? Should the requirements of this law be modified, and why? Under what circumstances, if any, should a bank decide not to conform to the requirements of Section 5200? What penalty, if any, exists for failure to observe this law?

What devices may the bank use in this case for meeting the requirements of Section 5200 while increasing the credit extended?

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[1] See American Bankers Association, *Manual of Laws Relating to Loans and Investments by National Banks*, which is based on the "Federal Laws Affecting National Banks as of January 1, 1936," compiled and published by the office of the Comptroller of the Currency. For an excellent explanation of the detail of Section 5200, see *Federal Reserve Bulletin*, October, 1937, pp. 993–995.

[2] For open-market rates, see Appendix III.

BRADSHAW MILLS

INTERIM REVOCATION OF CREDIT LINE TO A TEXTILE MILL

In February, 1932, the Manufacturers' National Bank of Richmond, Virginia, notified the Bradshaw Mills, a large manufacturer of velvets, velveteens, and corduroys, that its unsecured credit line of $80,000 had been reapproved. In acknowledging this notification, the mills informed the bank that confirmed credit lines totaling $650,000 were available from eight banks. During March the bank received information which indicated that the risk involved in making loans to the mills would be greater than had been expected. Consequently, it decided that the credit line should be discontinued.

During 1930 the Manufacturers' National Bank had solicited successfully the active use of the Bradshaw Mills' deposit account which had been dormant for a number of years, and in January, 1931, the bank had approved a credit line of $80,000 on the basis of statements shown in Exhibit 1. The mills borrowed during the first four months of that year, and maintained satisfactory balances with the bank. They requested no loans during the first three months of 1932.[1]

The revocation of the credit line in March, 1932, was due to a decision reached by the Manufacturers' National Bank and other creditors concerning the chief competitor of the Bradshaw Mills. The competitor was heavily in debt, and the creditors had decided to force liquidation of its very large stocks of velveteen, although such an action would undoubtedly depress market prices from 85 cents to 25 cents a yard. One-half of the inventory of the Bradshaw Mills consisted of velveteen of the same kind as that held by the competitor.

[1] Average borrowings and balances of the Bradshaw Mills from the Manufacturers' National Bank, 1931 (in thousands of dollars):

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Borrowings	50	40	35	25	..	..	..	..	..	..	..	..
Balances	8	10	9	11	8	8	9	7	8	8	7	8

The Manufacturers' National Bank always notified customers immediately after making a change in the status of their credit

EXHIBIT 1

Financial Statements of the Bradshaw Mills, as of December 31, 1928 to 1931*

	1928	1929	1930	1931
Assets				
Cash	$ 21,117	$ 35,651	$ 29,566	$ 75,614
Accounts Receivable	255,079	264,014	145,257	129,447
Raw Material and Goods in Process†	123,525	134,020	68,884	17,259
Finished Cloth†	420,699	614,860	692,833	449,493
Current Assets	$ 820,420	$1,048,545	$ 936,540	$ 671,813
Plant, Net	774,883	782,012	785,728	740,020
Investment in Affiliate	3,851	4,852	4,852	4,852
Prepaid Items	13,692	17,049	19,504	15,859
Total Assets	$1,612,846	$1,852,458	$1,746,624	$1,432,544
Liabilities				
Notes Payable	$ 35,000	$ 215,000	$ 215,000	$ 83,000
Accounts Payable	13,270	13,544	3,634	23,454
Reserves	46,493	43,101	11,115	11,115
Current Liabilities	$ 94,763	$ 271,645	$ 229,749	$ 117,569
Capital Stock	750,000	750,000	750,000	750,000
Surplus	768,083	830,813	766,875	564,975
Total Liabilities	$1,612,846	$1,852,458	$1,746,624	$1,432,544
Sales‡	$1,900,000	$2,000,000	$1,200,000	$ 960,000
Profits‡	186,000	200,000	3,000	170,000 (d)
Dividends‡	33,800	33,800	37,400	30,000
Current Ratio	8.66–1	3.86–1	4.08–1	5.71–1
Net Worth—Debt	16.02–1	5.82–1	6.60–1	11.18–1
Net Worth—Fixed Assets	1.96–1	2.02–1	1.93–1	1.78–1
Merchandise—Receivables	2.13–1	2.84–1	5.24–1	3.61–1
Collection Period	49 days	48 days	44 days	49 days
Sales—Merchandise	3.49–1	2.67–1	1.58–1	2.06–1
Sales—Net Worth	1.25–1	1.27–1	.79–1	.73–1
Sales—Fixed Assets	2.45–1	2.56–1	1.53–1	1.30–1
Profit on Sales	9.79 %	10.00 %	.25 %	(d)
Profit on Net Worth	12.25 %	12.65 %	.20 %	(d)
Acid Test	2.91–1	1.10–1	.76–1	1.74–1

* Audited.
† Valued at the lower of cost or market.
‡ Approximate amounts.
(d) Deficit.

lines, although such a policy was not common to all banks. Accordingly, on April 7, 1932, the president of the bank wrote the treasurer of the Bradshaw Mills as follows:

Since I saw you last month I have taken an unusual interest in the velveteen market in connection with the affairs of your chief competitor. I am much disturbed over the lack of opportunity for them to distribute in an orderly way their tremendous stock of velveteen.

As this will have an effect on your business, I should like to have the chance of chatting with you if you are coming to Richmond in the near future. I should prefer that you not ask us for credit until we have had the opportunity of reviewing your affairs in this way and learning from you the effect of the present situation on your working capital position.

Did the bank have adequate reasons for interim revocation of the credit line?

What other reasons, if any, would provide satisfactory grounds for a cancellation of credit line upon interim dates?

Why does the recipient of a credit line refuse to borrow the full amount at once? Would not the recipient be more assured of having funds in time of need if the full amount had been borrowed at the time the credit line was established?

Indicate the essential differences to both bank and customer between loans made and credit lines granted.

When a credit line is granted what do bankers and customers severally believe to be their rights and obligations?[1]

Need customers be notified promptly when credit lines are revoked?

Does the grant of a credit line presumably create a legally enforceable contract to loan money? If so, what would be the probable measure of damages in a suit against a bank?

Would the obligation of a bank be different if it were the sole bank granting credit lines to the customer?

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[1] For the banker's view, see Robert Morris Associates, "Questionnaire on Bank Credit Lines," supplement to the *Bulletin*, April, 1938.

CONRAD TEXTILE COMPANY

EXTENSION OF CREDIT TO THE RAYON MANUFACTURING SUBSIDIARY OF A TEXTILE MILL

The Amsterdam Trust Company of New York City transacted a large amount of business with the Conrad Textile Company, a large manufacturer of medium-grade cotton and rayon fabrics, having plants located in North and South Carolina. Exhibit 1 gives the record of transactions occurring between this company and the bank from January, 1927, to March, 1930, inclusive.

Prior to 1928 the Conrad Textile Company had imported nearly all of its rayon yarn, making payments under a $1,000,000 acceptance credit granted by the Amsterdam Trust Company. In 1927, however, the company decided to erect a small rayon plant of its own and to purchase only to cover its peak requirements. In order to compensate itself for the business which would be lost through the lessened use of this acceptance credit, the Amsterdam Trust Company aggressively solicited a greater proportion of the borrowings which the Conrad Textile Company made on its plain note, and the bank was successful in securing the promise of a larger share of this business. Accordingly, in February, 1928, the Amsterdam Trust Company extended a $1,000,000 line of credit to the company, charging 4½% on loans and agreeing to pay 1¾% interest on balances. No use was made of this line until the fall of 1928, and when, in January, 1929, the bank raised the rate on loans to 5¼%, the company became somewhat dissatisfied and its borrowings were light and intermittent until November and December of the latter year.

Aside from this slight dissatisfaction over the interest rate on loans on the company's plain note, the bank's relations with the Conrad Textile Company were pleasant. The company continued to borrow against pledged cotton, paying 5% to 6% interest, and its account was so inactive that ledger balances were practically synonymous with net balances.

EXHIBIT 1

Monthly Averages of Borrowings and Balances, January, 1927 through March, 1930

Month	Dollar Acceptances against Acceptance Credit	Collateral Loans on Pledged Cotton*	Straight Paper	Average Ledger Balance
1927				
January	$240,000	$640,000	....	$ 1,900
February	320,000	640,000	....	1,900
March	490,000	320,000	....	1,900
April	490,000	470,000	....	1,900
May	490,000	480,000	....	1,900
June	450,000	425,000	....	1,900
July	420,000	240,000	....	1,900
August	380,000	60,000	....	1,900
September	320,000	130,000	....	1,900
October	150,000	230,000	....	1,900
November	35,000	400,000	....	1,900
December	....	670,000	....	1,900
1928				
January	....	680,000	....	1,900
February	....	680,000	....	5,600
March	....	600,000	....	4,900
April	....	645,000	....	8,500
May	....	500,000	....	8,500
June	....	570,000	....	7,200
July	....	675,000	....	8,400
August	....	730,000	....	4,800
September	....	845,000	....	7,300
October	180,000	....	$200,000	90,100
November	270,000	....	300,000	114,100
December	420,000	....	300,000	118,700
1929				
January	....	540,000	200,000	123,900
February	....	600,000	300,000	103,400
March	....	580,000	....	101,400
April	....	480,000	200,000	107,900
May	....	440,000	....	101,100
June	....	505,000	....	101,300
July	....	485,000	....	101,400
August	....	450,000	200,000	127,700
September	....	375,000	200,000	112,400
October	....	18,000	....	102,400
November	....	150,000	400,000	137,600
December	....	300,000	500,000	129,200
1930				
January	300,000	....	600,000	126,700
February	300,000	....	700,000	134,600
March	300,000	....	800,000	151,000

* Secured by warehouse receipts covering cotton valued at 120 % of loan.

In February, 1930, the Thomas Rayon Mills, Incorporated, the rayon producing subsidiary of the Conrad Textile Company, completed its first full year of operation. Up to that time, the subsidiary had required of its parent company approximately $4,250,000. Of this amount $1,000,000 had been secured from the Barlow National Bank of New York City on the rayon company's note endorsed by the Conrad Textile Company, another $1,750,000 had been obtained from the Conrad Textile Company as a permanent investment, and the balance had been advanced by the parent company in current account. In March the treasurer of the Conrad Textile Company called on the Amsterdam Trust

Company in connection with the arrangement of credit lines totaling $3,500,000 for the Thomas Rayon Mills, Incorporated. He stated that the Barlow National Bank had agreed to continue its present loan of $1,000,000 to the rayon company, and asked whether the Amsterdam Trust Company would be interested in extending a credit not to exceed $500,000 on the rayon company's one-year, 6% note bearing the endorsement of the Conrad Textile Company. The Thomas Rayon Mills, Incorporated, would keep no balances against this loan as the treasurer admitted that the money was needed for permanent capital. He explained that he was seeking the accommodation merely as a temporary expedient until such time as market conditions became more favorable for the sale of stock to the public. The treasurer promised that he would have an audited statement of Thomas Rayon Mills, Incorporated, in the bank's hands within a month. He wished to know what action the bank would take on the proposition before this statement was ready.

Before giving an answer, the Amsterdam Trust Company sent two of its officers to inspect the rayon plant. They reported that its output was small in relation to overhead expense, and that they believed operations were being carried on at a substantial loss. It was their opinion that at least $2,000,000 more would have to be put into the enterprise in order to make it profitable. At the same time, they considered the product, which was a standard grade of viscose rayon, entirely satisfactory, and were favorably impressed by the superintendent of the plant and his subordinates.

The Amsterdam Trust Company also consulted with representatives of the Barlow National Bank and learned that the Conrad Textile Company virtually had been promised $3,000,000 of the $3,500,000 it sought. The Barlow National Bank understood that the Whiteside National Bank of Philadelphia, which had had no previous dealings with the Conrad Textile Company, had expressed its willingness to grant the $500,000 which had been offered to the Amsterdam Trust Company.

At a meeting of the executive committee of the Amsterdam Trust Company held on the day before the bank was expected to answer, various objections to placing a credit line at the disposal of the Thomas Rayon Mills were brought out. In the first place, it seemed likely that in making this request for bank credit the Conrad Textile Company had in mind releasing its own capital which was tied up in advances to the rayon company,

as well as raising new money for the latter. While this action might be directed to improving the current position of the parent concern, it might mean that the Conrad Textile Company really was not as optimistic as it appeared to be concerning the possibility of financing for its subsidiary in the near future.

Secondly, the whole rayon venture was questionable for a concern the size of the Conrad Textile Company, since, in order to reach anything approaching an economical size, the rayon plant would require a fixed investment of between \$6,000,000 and \$7,000,000. A plant of this size would produce more rayon yarn than the Conrad Textile Company required for its own purposes, and profitable sales of the surplus yarn in the open market were doubtful because of competition with larger and more efficient plants.

In the third place, although the statement of the Thomas Rayon Mills, Incorporated, would not be received for another two weeks, the Amsterdam Trust Company was satisfied that the venture was losing money and that it would continue to do so for at least a year or two more. Consequently, the \$500,000 requested would be virtually an increase in the Conrad Textile Company's credit line. One of the bank's officers brought up the point in regard to the showing which the parent company's statement, shown in Exhibit 2, would make if notes payable to banks were increased from \$6,180,000 to \$9,680,000, even though the \$1,600,000 of advances were liquidated and applied to improving the current ratio.

On the other side of the question, there was the possibility of securing 6% interest for one year on \$500,000 at a time when commercial paper was bringing 4½% and call loans 3½%, with the possibility of some additional easing in rates. Furthermore, if the Amsterdam Trust Company did not extend this credit, there was the probability of losing the goodwill of the Conrad Textile Company. Finally, an officer of the bank's investment subsidiary brought out the point that, if the loan were made, the subsidiary might be given the opportunity of originating an issue of stock when the time came for doing permanent financing for Thomas Rayon Mills, Incorporated.

What is the fundamental question at issue in passing on this credit?

What decision should be made?

EXHIBIT 2

Financial Statements of Conrad Textile Company*

	December 31 1927	December 31 1928	June 30 1929	December 31 1929
Assets				
Cash	$ 593,612	$ 691,103	$ 562,658	$ 1,529,456
Accounts Receivable	3,601,566	3,397,160	3,637,110	1,924,004
Merchandise (Including Cotton Pledged)	12,450,829	12,934,975	9,987,835	11,482,738
Cash Value Life Insurance Policy	256,986	288,539	295,432	320,297
Current Assets	$16,902,993	$17,311,777	$14,483,035	$15,256,495
Land, Buildings, & Equipment	28,224,386	28,402,004	29,100,059	29,323,518
Investments in Affiliated Companies	623,986	1,226,275	1,291,007	1,735,699
Deferred Charges and Prepaid Items	428,515	382,547	289,877	284,818
Miscellaneous Accounts Receivable	128,471	189,299	45,382	252,753
Due from Subsidiary	....	758,452	1,972,930	1,613,195
Other Assets	....	....	130,030	132,671
Total Assets	$46,308,351	$48,270,354	$47,312,320	$48,599,149
Liabilities				
Notes Payable—Banks	$ 4,050,000	$ 4,320,000	$ 3,720,000	$ 6,180,918
Accounts Payable	1,699,522	1,748,152	615,573	654,230
Acceptances	1,560,000	2,880,000	2,640,000	2,340,000
Sundries and Accruals	296,428	126,006	376,438	93,589
Dividends Payable	234,962	234,962	....	....
Current Liabilities	$ 7,840,912	$ 9,309,120	$ 7,352,011	$ 9,268,737
Preferred Stock	13,426,440	13,426,440	13,426,440	13,426,440
Common Stock	14,400,000	14,400,000	14,400,000	14,400,000
Surplus	10,640,999	11,134,794	12,133,869	11,503,972
Total Liabilities	$46,308,351	$48,270,354	$47,312,320	$48,599,149
Net Profits	$ 2,625,588	$ 1,639,794	$ 902,045†	$ 1,284,065
Dividends Paid	704,888	939,851	....	704,888
Contingent Liabilities	....	1,182,000	1,200,000	1,200,000
Current Ratio	2.15–1	1.85–1	1.96–1	1.64–1
Net Worth—Debt	4.90–1	4.18–1	5.43–1	4.24–1
Net Worth—Fixed Assets	1.36–1	1.37–1	1.37–1	1.34–1
Merchandise—Receivables	3.45–1	3.80–1	2.74–1†	5.96–1
Acid Test	.53–1	.43–1	.57–1	.37–1
Profit on Net Worth	6.82 %	4.20 %	2.25 %†	3.26 %

* Audited.
† Six months.

HOGAN CORPORATION

BANK LOANS TO FINANCE PERFORMANCE OF CONTRACTS[1]

On November 30, 1933, the president of the Hogan Corporation asked the Mohawk National Bank of Albany, New York, to agree to finance any or all of three new jobs for which he was preparing estimates. The corporation would require the aid of the bank in financing bids; and, if a contract or contracts should be awarded, it would be necessary for the bank to furnish working capital for the actual construction activity. It had been the practice of the bank to advance funds for a bid check beyond the normal credit line, because under ordinary circumstances such a loan would be outstanding only a day or two.[2]

The president told the credit manager of the bank that the basis used for all the bids was the corporation's estimated cost of the work plus 15% for profit; on work which the corporation planned to sublet, 5% was added to the bid submitted by the subcontractor. The president reported that payments on these projects would be made semimonthly.

The projects under consideration were:

1. *Constructing the Hudson River Bridge.*—The total bid would be over $600,000, half of which would be sublet. The corporation would need working capital of $20,000 during the first six weeks. Thereafter it was expected that the job would finance itself, although the borrowings might reach a peak of $30,000 between the dates when the corporation would receive money from the state.[3] The bid check would be for $18,000.

[1] Consult Hauer, D. J., *The Economics of Contracting*, Vol. I, Chs. II–IV.

[2] It is the custom of states and municipalities to require a "bid check" to accompany each bid. The amount of the check is either stipulated by the engineer or is a stated percentage (usually 5% or 10%) of the bid. The purpose of this requirement is to guarantee that the contractor will enter into a contract for the work if the bid is accepted. The check is forfeited if the bid is accepted and the contractor does not enter into the contract. It is returned immediately if the bid is not accepted, and as soon as the contract is signed if the bid is accepted.

The bid check should not be confused with the bond that is required of a contractor after the bid is accepted. The purpose of the bond is to insure the completion of the job; the purpose of the check is to insure the genuineness of the bid and the ability of the contractor to undertake the work. In some localities, however, a "bid bond" may be substituted for the bid check.

[3] States and municipalities usually pay contractors at regular intervals. The payments are made semimonthly (or monthly) on "engineers' estimates." The

2. *Paving a State Road.*—The total bid would amount to $250,000, and the work would last well into the spring. The president, however, believed that this bid was high and that there was little chance of receiving the contract. He explained that high bids were submitted to have the psychological effect of raising bids on future jobs. Ten thousand dollars would be necessary for a bid check.

3. *Building Approaches to a New River Tunnel.*—This work would include two miles of road and four bridges. The bid would be $1,200,000, and the corporation would sublet $200,000 for the steelwork and pile driving but would do the rest of the work with its own organization. The job would be completed in 10 months. Since the labor expenses on this job amounted to 30% of the contract, the financial requirements would have to be met punctiliously. The bid check would be for $35,000.

The Hogan Corporation had been organized in 1907 with a capital of $50,000 to continue a general contracting business started in Albany in 1892. Subsequently, a new management had come into control, and the capital was increased to $300,000, all of which was issued and paid in at a par value of $100 per share. In January, 1923, the corporation had opened its account with the Mohawk National Bank and thereafter had been financed solely by that institution. The more recent financial statements which it furnished the bank were as shown in Exhibit 1.

The corporation and its officers were highly regarded in the trade and considered prompt in the payment of bills. At different times throughout the bank's relations with the corporation, the opinions of both creditors and customers had been obtained and found highly satisfactory. Recent replies included such phrases as: "bills are invariably discounted," "very fine men with excellent reputations," "absolutely A-1," and "we have been highly satisfied with any work they have undertaken for us."

The vice president and the treasurer of the corporation owned and operated the Mulcahy Equipment and Supply Company, which rented construction equipment to contractors. Although equipment was rented to others, the principal customer was the Hogan Corporation. The bank had the account of the equipment

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engineers estimate on each payment date the total value of the work already done. From this total is deducted a reserve of 15%, and also the payments which have been made previously on the contract. The balance is then paid to the contractor in cash. The 15% reserve is retained until the job is completed, and usually beyond the date of completion for a sufficiently long period to judge the perfection of the work and to pay for expenses incurred because of any poor workmanship on the part of the contractor.

EXHIBIT I

Financial Statements of the Hogan Corporation as of December 31, 1925 to 1932, and October 31, 1933
(000 omitted)

	1925	1926	1927	1928	1929	1930	1931	1932*	October 31, 1933
Assets									
Cash	$ 46	$ 32	$ 45	$ 52	$ 89	$ 45	$ 24	$ 9	$ 11
Notes Receivable	......	12	43	11	4	3	3	3	5
Accounts Receivable	236	511	575	467	248	221	199	71	125
Merchandise	11	12	29	18	16	27	8	12	7
Reserve on Uncompleted Contracts	340	....	.....	134	......	......	80	26	99
Cash Value of Life Insurance	...	....	10	17	20	24	27	28	....
Current Assets	$ 633	$567	$ 702	$ 699	$ 377	$ 320	$ 341	$149	$247
Land, Buildings, and Other Real Estate	251	179	176	601	593	585	578	571	566
Machinery, Furniture, and Equipment	106	117	124	108	126	129	106	92	71
Investments	47	17	17	9	9	9	9	9	9
Due from Officers and Employees	......	....	.....	......	......	7	9	9	....
Deferred Charges and Other Assets	8	8	8	6	7	1	2	3	3
Total Assets	$1,045	$888	$1,027	$1,423	$1,112	$1,051	$1,045	$833	$896
Liabilities									
Notes Payable—Banks	......	$ 84	$ 153	$ 70	......	......	......	$ 60	$ 33
Accounts Payable	$ 131	365	434	251	$ 103	$ 89	$ 106	110	136
Due Officers and Employees	......	...	......	46	19	......	9	6	....
Reserves Payable to Subcontractors	......	...	......	123	......	......	54	2	50
Advances on Contracts	373	....	......	......	......	......	......	....	....
Loans on Life Insurance	......	....	......	......	......	......	......	26	....
Other Current Liabilities	32	9	......	39	71	35	......	32	9
Current Liabilities	$ 536	$458	$ 587	$ 529	$ 193	$ 124	$ 169	$236	$228
Mortgage on Real Estate	......	....	......	400	400	400	400	304	304
Common Stock	300	300	300	300	300	300	300	300	270†
Surplus	209	130	140	194	219	227	176	7(d)	94
Total Liabilities	$1,045	$888	$1,027	$1,423	$1,112	$1,051	$1,045	$833	$896
Sales	......	....	......	......	$1,983	$1,623	$2,015	$439	....
Net Profits	......	....	......	......	97	39	51(d)	184(d)	....
Dividends Paid	......	....	......	$ 30	60	30	....	.....	....
Current Ratio	1.18	1.24	1.20	1.32	1.95	2.58	2.02	.63	1.08
Net Worth—Debt	.95	.94	.75	.53	.88	1.01	.84	.54	68
Net Worth—Fixed Assets	1.43	1.45	1.47	.70	.72	.74	.70	.44	.57

* Audited.
† Does not include stock in treasury.
(d) Deficit.

company, the payroll account of the corporation, and the personal account of the president of the latter.

Until 1928 the Hogan Corporation had been interested in both construction and paving contracts. At that time it decided to specialize in paving and to discontinue the building construction business, which was unprofitable. This decision was influenced somewhat by the fact that during 1928 the corporation was forced to repossess a five-story building on which the owner was unable to meet the payments and to assume a mortgage of $400,000.

On March 1, 1932, this mortgage, which was held by the Hudson Savings Bank, fell due and was extended for one year *only* after the corporation had paid $76,000 on the principal and agreed to make two additional payments of $10,000 each in June and September of 1932. The funds needed for the initial payment were obtained from the cash assets of the corporation, the proceeds of a loan on a life insurance policy in which the corporation was named as beneficiary, and the reduction of accounts receivable. It was estimated that the accounts receivable were reduced $66,000 from January 1 to March 1, 1932. Some facts regarding the mortgaged property are contained in the auditors' report for 1932, parts of which are given in Exhibit 2. Although the auditors reported that the corporation was not delinquent on any provision of the mortgage, the bank discovered by independent investigation that real estate taxes of approximately $13,200 were due and unpaid at the end of 1932.[1]

In November, 1932, the corporation had received a contract from the state for paving a section of highway. It amounted to $400,000, of which approximately $160,000 was sublet to other contractors. At that time arrangements were concluded with the Hudson Savings Bank to extend the due date of the remaining $304,000 principal of the mortgage to March 1, 1934, but the corporation was required to promise to pay $12,000 in November, 1933. Since the corporation expected to complete the paving contract before July 1, 1933, and since the Mulcahy Equipment and Supply Company, as well as the officers of the corporation, agreed to subordinate their claims, totaling $16,000, the Mohawk National Bank agreed to finance the job to the extent of $50,000.

The audited report of December 31, 1932, indicated a loss for the year. The bank thereafter renewed the corporation's matur-

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[1] Under the New York tax laws, delinquent taxes incurred a penalty equivalent to 10% per annum until paid. Property was not sold for delinquent taxes until one year after the due date and could be redeemed within one year after sale.

EXHIBIT 2

Excerpts from Auditor's Report for 1932 of the Hogan Corporation
(In thousands of dollars)

Profit and Loss	Year Ending December 31	
	1931	1932
Sales	2,015	439
Material, labor, and operating expenses	1,884	485
General expenses	146	105
Miscellaneous charges	46	37
Operating loss	61	188
Other income not from building	11	4
Net loss	50	184
Gross income from building	....	36
Taxes	....	18
Interest	....	18
Depreciation	....	6
Expenses	....	17
Loss from building	....	23

Notes on Balance Sheet Items, December 31, 1932

Real estate used in business	
Assessed valuation	44
Booked at depreciated value	38
Real estate not used in business	
Cost of land	276
Cost of building, less depreciation	257
Total cost of land and building	533
Assessed valuation of land and building	500
Mortgage, due March 1, 1934	304
Accounts receivable	
Under 90 days	65
90–120 days	4
Over 120 days (less reserve $2)	2
	71

ing notes only on a demand basis and refused to increase the amount of working capital advanced. At the same time the corporation took measures to reduce expenses and to improve its operating results. During 1932 three of the officers had been receiving salaries totaling $27,000 a year. In the early part of 1933 these were reduced to $5,000 each, and it was reported that other savings had been effected, so that the total reduction in expenses would amount to nearly $50,000 per year. While the

EXHIBIT 3

Borrowings and Balances of the Hogan Corporation at the Mohawk National Bank, 1925 to 1933
(In thousands of dollars)

Month	Maximum Unsecured "Time" Borrowings*	Maximum Unsecured Demand Loans†	Average of Daily Balances	Maximum Unsecured "Time" Borrowings*	Maximum Unsecured Demand Loans†	Average of Daily Balances
		1925			1930	
January	....	....	52.0	....	....	110.6
February	....	....	44.8	....	....	120.4
March	....	....	29.0	....	....	99.0
April	30	....	34.2	....	....	69.2
May	60	....	42.8	....	6.0	25.4
June	80	....	69.4	20	6.0	30.8
July	60	....	37.2	60	6.0	49.6
August	60	100	58.8	60	14.0	102.4
September	60	....	71.2	40	8.0	109.2
October	90	....	83.2	....	....	125.4
November	90*	....	61.0	....	....	156.4
December	80*	....	100.6	....	....	104.2
		1926			1931	
January	60*	....	79.0	....	....	58.4
February	20*	30	23.6	....	....	68.4
March	40*	50	26.8	....	....	56.0
April	40*	20	22.0	20	30.0	23.8
May	70*	20	21.6	20	8.0	17.0
June	100*	30	31.0	40	12.0	43.6
July	100*	39	59.6	40	26.0	73.8
August	100*	10	90.4	60	10.0	110.8
September	100*	50	89.8	80	8.7	57.0
October	100	50	81.2	100	11.0	60.0
November	100	50	103.4	80	6.0	49.2
December	80	....	82.2	60	7.5	72.2
		1927			1932	
January	61.8	....	98.6	....	...	49.2
February	....	50	32.2	20	3.0	31.4
March	....	6	41.4	20	16.0	9.4
April	....	25	44.2	....	7.2	11.8
May	....	30	39.8	20	8.8	28.4
June	40.0	30	30.4	20	7.0	11.6
July	80.0	40	46.6	20	22.4	12.8
August	120.0	....	71.0	20	40.0	50.6
September	120.0	....	68.2	20	19.0	23.6
October	150.0	....	99.0	20	20.0	14.6
November	150.0	20	98.2	40	5.0	17.4
December	150.0	20	73.2	60	3.7	15.0
		1928			1933	
January	150	....	66.6	60	2.0	16.2
February	150	....	52.0	60	4.0	14.8
March	150	....	59.0	40	19.0	12.8
April	150	....	54.4	10	56.0†	12.4
May	150	26.2	40.0	....	68.0†	13.8
June	150	10.0	54.0	....	60.0†	21.6
July	130	12.0	52.6	....	50.0†	29.6
August	130	....	67.8	....	30.0†	23.0
September	130	....	85.8	....	32.4†	17.0
October	110	....	79.4	....	30.0†	11.0
November	70	....	86.4	....	....	....
December	70	....	73.6	....	....	....
		1929				
January	30	....	117.2			
February	....	....	67.0			
March	....	30.0	31.7			
April	20	28.2	8.6			
May	60	42.0	20.2			
June	100	26.6	34.6			
July	100	2.0	44.2			
August	80	....	98.0			
September	80	20.0	90.2			
October	80	....	112.2			
November	20	....	98.6			
December	....	....	110.6			

* In addition some "Notes Receivable" were rediscounted from November, 1925, to September, 1926; highest amount, $10,200.

† Until April, 1933, when the time borrowings were changed to a demand basis, the unsecured demand loans were made chiefly to provide certified bid checks which remained outstanding only a few days.

expenses were being readjusted, the vice president of the corporation resigned and transferred most of his stock to the corporation in return for the cancellation of its claims against him. This stock was retained in the treasury in the hope that it could be sold to someone interested in the business and the proceeds applied to working-capital requirements.

On November 30, 1933, the corporation owed the bank $30,000. It had surrendered the life insurance policy and had not succeeded in selling the stock it held in its treasury. Since the corporation lacked working capital, it would be unable to accept any of the proposed contracts if the bank did not agree to finance them. It expected to finish soon the state paving job planned for completion on July 1. The final settlement would amount to $90,000. Of this amount $46,000 was due subcontractors, and the bookkeeper estimated that an additional $24,000 would be due for materials. Since these claims would probably be prior to those of the bank, there would be only $20,000 to apply on the bank loans. It was ascertained that the $12,000 which became due upon the principal of the mortgage in November had not been paid.

Borrowings and balances of the corporation were as shown in Exhibit 3.

Wherein, if at all, does the character of the assets of a typical contracting concern differ from those of a manufacturer or a merchandiser? What is the banking risk in extending accommodation to contractors in the form of bid checks? In financing construction jobs?

Should a bank furnish a bid check if it is not willing to finance the actual construction for which a bid is being submitted?

Estimate the probable outcome for the bank if it agrees to finance any or all the jobs as requested. Should the bank agree to furnish bid checks or to finance any of the proposed jobs? What would be the maximum outstandings under such an agreement?

What disposition should be made of the $30,000 loan outstanding?

Is there any way in which the corporation might rid itself of the burden of its mortgage indebtedness?

How much importance should be attached to the date of this case?

BELL, WAHL AND COMPANY

EXTENSION OF CREDIT TO A PUBLISHING COMPANY

Bell, Wahl and Company of Boston, Massachusetts, was founded in 1900 to do a commercial printing and lithographing business. After several years of operation, the concern took steps to free itself from dependence upon special-order printing because of the keen competition which it faced from better established firms. The first step toward diversification was the publication of children's books, which ranged in price from $1 a copy downward. Sales were made largely to the department store trade.

In 1923 the company began the manufacture of inexpensive playing cards, which were sold through the large 10-cent stores. This venture proved so successful that the company decided to try the same outlet for the book department. Accordingly, a line of children's books to retail at 10 cents was developed. The sales and profits of the company expanded rapidly after its products had become firmly established in the 10-cent store market. Although its commercial printing was continued, the company made over two-thirds of its sales in 1930 in books and playing cards, as shown in Exhibit 1.

EXHIBIT 1

Classification of Sales of Bell, Wahl and Company, 1926 and 1930

	1926		1930	
	Volume	Per Cent	Volume	Per Cent
Books	$ 714,294	36.3	$1,706,631	40.2
Playing Cards	370,739	18.8	1,156,995	27.3
Commercial Printing	884,889	44.9	1,380,669	32.5
Total	$1,969,922	100.0	$4,244,295	100.0

Two difficult problems arose from the policy of concentrating on inexpensive products. In the first place, mass production, involving the most modern equipment and laborsaving devices,

was necessary in order to compete successfully for the 10-cent store trade. Consequently, an extensive building program was carried out between 1926 and 1930. The old plant was devoted entirely to commercial printing and storage, and new buildings were erected to accommodate the book and playing card departments.

The second important problem was the question of production and inventory control. Large runs of both playing cards and books were essential in order to keep unit costs low. Consequently, a half-year's supply of one book frequently was turned out before type was reset on the book presses. Sales of both cards and books, and especially of books, were highly seasonal, however. Approximate monthly sales for 1929 and 1930 are shown in Exhibit 2. This combination of circumstances made it necessary for the company to carry large stocks of seasonal merchandise, particularly during the late spring and summer months. A premium was placed on accurate sales forecasting and on the selection of books which were certain to meet with a large popular demand.

EXHIBIT 2
Monthly Sales of Bell, Wahl and Company, 1929 and 1930

	1929		1930	
	Volume	Per Cent	Volume	Per Cent
January	$ 194,000	5.0	$ 238,000	5.6
February	261,000	6.7	266,000	6.3
March	296,000	7.6	293,000	6.9
April	339,000	8.7	262,000	6.2
May	229,000	5.8	157,000	3.7
June	187,000	4.8	139,000	3.3
July	206,000	5.3	182,000	4.3
August	354,000	9.0	419,000	9.9
September	433,000	11.1	514,000	12.1
October	413,000	10.6	631,000	14.8
November	569,000	14.5	695,000	16.4
December	426,000	10.9	448,000	10.5
Total	$3,907,000	100.0	$4,244,000	100.0

The Earle National Bank had secured an account from the company in 1916, shortly after the publication of books was begun. From time to time the bank had made loans to help the company carry its inventory, but no definite line of credit was

extended until the spring of 1927. At that time, the concern was granted an unsecured line amounting to $200,000. This was increased to $300,000 in 1929, and in March, 1931, Mr. A. B. Bell, the president of the concern, asked the Earle National Bank to place a credit line of $500,000 at the disposal of his company.

The experience of the bank with the company had been entirely satisfactory. The management was well known to the bank and was made up of men of ability and judgment. Mr. Bell had held the office of president for 31 years. The company always had met its notes promptly at maturity. Borrowings had been intermittent, and balances, while not absolutely commensurate with loans, had been adequate. The company's deposit account was profitable for the bank. At the time that the bank was asked to increase its commitment to $500,000, the company had a connection with one of the most reputable commercial paper brokers in New England. This house had agreed to take the company's open-market paper in any amount not to exceed $1,250,000 during the year 1931. Three other Boston banks extended credit lines totaling $1,000,000. Bank and trade checkings on the company were uniformly favorable.

The bank was well satisfied with the manner in which the company had handled the financing of its new plant. The common stock and a large block of the 7% preferred stock was held by the company's four chief executives. These men drew liberal salaries, but every year they reinvested a substantial portion of their compensation in the company's shares. The balance sheet item, Miscellaneous Notes and Accounts Receivable, represented almost entirely the notes of officers given for stock subscriptions. Furthermore, the company had paid no cash dividends on its common stock since 1926, all net earnings after preferred dividends being retained in the business. These additions to capital had enabled Bell, Wahl and Company to carry out its building program with a minimum amount of outside financing in the form of a moderate-size bond issue. The volume of business done in 1929 and 1930 attested to the foresight of the management in providing enlarged plant facilities.

In the year 1926, the A. B. Bell Company and the Bell Land Company had been organized. The entire capital stock of these two concerns was owned by officers of Bell, Wahl and Company. The A. B. Bell Company was a sales organization which carried the receivables of the book and playing card departments; the

Financial Statements of Bell, Wahl and Company, as of December 31, 1926 to 1930*

	1926	1927	1928	1929	1930
Assets					
Cash	$ 51,716	$ 33,471	$ 50,779	$ 63,886	$ 68,681
Notes Receivable	11,225	24,134	8,500	9,560	15,096
Accounts Receivable	207,550	189,135	288,589	363,972	251,158
Inventory	460,688	531,878	452,188	797,054	1,284,149
Current Assets	$ 731,179	$ 778,618	$ 800,056	$1,234,472	$1,619,084
Stocks and Bonds (at cost)	24,527	1,250	14,280	16,810	18,020
Stock of Affiliated Companies	....	....	....	....	93,750
Miscellaneous Notes and Accounts	144,974	353,542	289,364	133,130	243,206
Real Estate, Buildings, and Equipment	480,680	1,203,811	1,469,545	1,652,064	1,929,602
Deferred Charges	5,273	9,520	22,881	34,419	19,460
Total Assets	$1,386,633	$2,346,741	$2,596,126	$3,070,895	$3,923,122
Liabilities					
Notes Payable—Banks and Brokers	$ 81,500	$ 112,500	$ 143,750	$ 162,500	$ 450,000
Other Notes Payable	6,000	....	2,500	44,500	....
Accounts Payable	60,685	66,410	65,552	77,860	63,854
Accruals	28,986	47,358	73,111	92,088	96,629
Current Liabilities	$ 177,171	$ 226,268	$ 284,913	$ 376,948	$ 610,483
6% First-mortgage Bonds	....	427,000	500,000	500,000	470,000
Real Estate Mortgages	84,441	....	....	....	....
7% Preferred Stock	460,000	625,000	625,000	625,000	805,000
Common Stock	450,000	612,500	609,000	625,000	1,037,500
Surplus	215,021	455,973	577,213	943,947	1,000,139
Total Liabilities	$1,386,633	$2,346,741	$2,596,126	$3,070,895	$3,923,122
Sales	$1,969,922	$2,271,293	$3,001,918	$3,906,517	$4,244,295
Cost of Goods Sold	1,423,046	1,635,978	2,357,073	2,622,206	3,099,249
Gross Profit	$ 546,876	$ 635,315	$ 644,845	$1,284,311	$1,145,046
Net Profit	93,719	150,884	185,730	456,852	335,446
Preferred Dividends	21,875	32,200	43,750	43,750	43,750
Common Dividends	78,125	....	....	....	312,500 (in stock)

* Audited.

receivables shown on the statements of Bell, Wahl and Company represented only the amounts due on commercial work. Books and cards were shipped direct to customers but were billed in the name of the A. B. Bell Company. The parent concern charged its output of books and cards to the sales company monthly, and received monthly settlements from it. A rental of $10,000 a year for the use of plates and manuscripts was paid to the A. B. Bell Company in the form of preferred stock of Bell, Wahl and Company. The A. B. Bell Company borrowed in moderate amounts from two of the smaller banks which had accounts of the parent concern.

The Bell Land Company owned the buildings of the old Bell, Wahl and Company plant, which were mortgaged separately from the new plant. It held also the fee title to the land on which the new buildings stood. During 1930, Bell, Wahl and Company's commercial paper broker had suggested that it might help the sales of open-market paper if these intercompany relationships were simplified and if a consolidated statement were submitted covering every aspect of the business. The management had

EXHIBIT 4

Financial Statements of Companies Affiliated with Bell, Wahl and Company, as of December 31, 1930

A. B. Bell Company

Assets		Liabilities	
Cash	$ 236	Notes Payable	$137,250
Notes Receivable	7,591	Accounts Payable	56,198
Accounts Receivable	226,934		
Current Assets	$234,761	Current Liabilities	$193,448
Plates and Manuscripts	122,058	Capital Stock	150,000
Baer, Hood and Company Preferred Stock	45,000	Surplus	58,371
Total Assets	$401,819	Total Liabilities	$401,319

Bell Land Company

Assets		Liabilities	
Current Assets	$ 14,927	Current Liabilities	$ 17,144
Land and Buildings	268,399	Real Estate Mortgages	168,750
		Capital Stock	75,000
		Surplus	22,432
Total Assets	$283,326	Total Liabilities	$283,326

EXHIBIT 5

Ratios Computed upon Financial Statements of Bell, Wahl and Company, as of December 31, 1926 to 1930

	1926	1927	1928	1929	1930
Current Ratio	4.13–1	3.44–1	2.81–1	3.27–1	2.65–1
Net Worth—Debt	4.30–1	2.59–1	2.31–1	2.50–1	2.63–1
Net Worth—Fixed Assets	2.34–1	1.41–1	1.23–1	1.33–1	1.47–1
Merchandise—Receivables	2.11–1	2.49–1	1.52–1	2.13–1	4.82–1
Sales—Merchandise	4.28–1	4.27–1	6.64–1	4.90–1	3.31–1
Collection Period	41 days	34 days	36 days	35 days	23 days
Sales—Fixed Assets	4.10–1	1.89–1	2.04–1	2.36–1	2.20–1
Sales—Net Worth	1.75–1	1.34–1	1.66–1	1.78–1	1.49–1
Acid Test	1.53–1	1.09–1	1.22–1	1.16–1	.55–1
Profit on Sales	4.76 %	6.64 %	6.19 %	11.69 %	7.90 %
Profit on Net Worth	8.33 %	8.91 %	10.25 %	20.82 %	11.80 %

EXHIBIT 6

Ratios Computed upon the Combined Financial Statements of Bell, Wahl and Company, A. B. Bell Company, and Bell Land Company, as of December 31, 1930

Current Ratio	2.28–1
Net Worth—Debt	2.16–1
Net Worth—Fixed Assets	1.36–1
Merchandise—Receivables	2.56–1
Collection Period	43 days
Sales—Fixed Assets	1.82–1
Sales—Net Worth	1.34–1
Acid Test	.71–1
Profit on Net Worth	10.65%

not accepted this proposal at once but was considering it. In the meantime the parent company had purchased a substantial minority interest in the stock of each affiliate.

The vice president of the Earle National Bank who handled the account of Bell, Wahl and Company felt that the concern was entitled to a $500,000 line of credit in March, 1931. It was his opinion that the company's statements and those of its affiliates, which are reproduced and analyzed in Exhibits 3, 4, 5, and 6, showed the progress which was being made and the necessity for increased credit. The credit manager of the bank, however, objected to the granting of a larger line.

When Mr. Bell asked for an increase in the credit line, he was perfectly frank in stating that it was needed to finance the company's book inventory. He furnished the Earle National Bank with figures on the company's recent borrowings, shown in Exhibit 7, and with a classification of inventory, reproduced in Exhibit 8. It was on the inventory situation that the credit manager of the Earle National Bank based his objection to an increased line of credit for Bell, Wahl and Company. He believed

EXHIBIT 7

Range of Borrowings of Bell, Wahl and Company, 1929 and 1930

Borrowings	Low—January	High—August	Low—December
1929	$150,000	$1,125,000	$162,500
1930	195,000	1,475,000	450,000

EXHIBIT 8

Inventory Classification of Bell, Wahl and Company, as of December 31, 1926 to 1930

	1926	1927	1928	1929	1930
Finished Goods					
Books	$230,211	$260,763	Not Broken Down	$474,295	$ 923,982
Other	28,801	61,147		125,804	145,373
Goods-in-process	141,564	147,396		}196,955	214,794
Raw Material	60,112	62,572			
Total	$460,688	$531,878	$452,188	$797,054	$1,284,149

that several considerations bearing on the problem should be weighed carefully before reaching a decision. He pointed out that books in stock at the end of 1930 amounted to well over one-half of book sales for the entire preceding year, whereas in 1926 year-end inventory had been only 32% of annual book sales. He also suggested that the company's lower gross margin in 1930 might indicate that the 10-cent chains were refusing to pay such good prices now that they believed Bell, Wahl and Company to be dependent upon them for its sales outlet.

On the other hand, the vice president who had charge of Bell, Wahl and Company's account stated that the system of inventory control in use was excellent, and that one of the merchandise managers of a prominent 10-cent chain worked with Bell, Wahl and Company in planning production and estimating probable sales. The vice president understood that a large part of the finished books on hand on December 31, 1930, had been run during the late fall for the 1931 season and were on order by customers.

CUTLER HARDWARE COMPANY

EXTENSION OF CREDIT TO A RETAIL HARDWARE DEALER

In 1911 the Ashford National Bank of Charleston, South Carolina, granted a $30,000 line of credit to the Cutler Hardware Company, the largest retail hardware dealer in the city. Since that time relations between the bank and the company had been cordial. Ledger balances had been more than commensurate with loans,[1] the bank had not been requested to pay interest on balances, and the company willingly paid an unvarying rate of 5½% on borrowings. In addition, two officers of the Cutler Hardware Company kept personal accounts at the Ashford National Bank.

After the receipt of the Cutler Hardware Company's statement of March 1, 1930, included in Exhibit 1, Mr. Knowles, the manager of the credit department of the Ashford National Bank, consulted with Mr. Cleary, the vice president who handled the account. Mr. Knowles brought out a number of unfavorable aspects of the Cutler account. Although borrowings were not large, the company had not been out of the bank's debt since 1919, and it appeared that loans were in the nature of permanent capital required in the business. Since the Cutler Hardware Company had never furnished the bank with operating figures, it was impossible to obtain a satisfactory explanation of the successive reductions shown in its surplus account, but Mr. Knowles felt certain that these reductions could be ascribed either to unprofitable business or to the payment of excessive dividends. It was apparent from the Cutler Company's comparative balance sheets that the concern was making no progress, and it

[1]

Year	Average Loan	Average Ledger Balance
1926	$24,000	$13,600
1927	14,000	14,000
1928	11,000	8,800
1929	15,000	6,500

seemed probable that the business was actually losing money. As shown by Exhibit 2, the account was an active one, and the float of checks outstanding reduced net balances to about 50% of ledger balances, a condition which resulted in a smaller profit to the bank than would be indicated by a casual examination of loans and balances.

EXHIBIT 1

Financial Statements of the Cutler Hardware Company, as of March 1, 1926 to 1930*

	1926	1927	1928	1929	1930
Assets					
Cash	$ 19,260	$ 4,965	$ 8,880	$ 14,350	$ 5,539
Accounts and Notes Receivable	122,458	136,184	145,781	112,282	123,577
Merchandise	154,130	152,219	138,278	138,375	142,323
Current Assets	$295,848	$293,368	$292,939	$265,007	$271,439
Furniture and Fixtures	11,955	10,037	8,344	9,553	7,448
Investments	1,101	670	670	1,070	1,070
Deferred Charges and Prepaid Items	4,064	2,572	5,112	3,609	3,779
Total Assets	$312,968	$306,647	$307,065	$279,239	$283,736
Liabilities					
Notes Payable—Borrowed Money	$ 25,000	$ 15,000	$ 10,000	$ 10,000	$ 15,000
Accounts Payable	26,753	41,622	50,232	27,621	32,983
Accruals	67	377	949	1,048	1,190
Current Liabilities	$ 51,820	$ 56,999	$ 61,181	$ 38,669	$ 49,173
Preferred Stock	100,000	100,000	100,000	100,000	100,000
Common Stock	100,000	100,000	100,000	100,000	100,000
Surplus	61,148	49,648	45,884	40,570	34,563
Total Liabilities	$312,968	$306,647	$307,065	$279,239	$283,736
Current Ratio	5.70–1	5.14–1	4.78–1	6.85–1	5.52–1
Net Worth—Debt	5.03–1	4.37–1	4.01–1	6.22–1	4.77–1
Not Worth—Fixed Assets	21.84–1	24.87–1	29.46–1	25.18–1	31.49–1
Merchandise—Receivables	1.25–1	1.11–1	.94–1	1.23–1	1.15–1
Acid Test	2.73–1	2.47–1	2.52–1	3.27–1	2.62–1

* Not audited, but signed by treasurer.

EXHIBIT 2

Analysis of the Cutler Hardware Company's Account for 1929

Average Loan	$15,000.00
Interest Collected on Average Loan at 5½%	825.00
Activity Cost 4,553 Items at 2¼ Cents	102.44
Net Revenue	722.56
Average Ledger Balance	6,470.00
Average Uncollected Balance	3,180.00
Average Reserve Required against Ledger Balance*	452.90
Average Net Loanable Funds	2,837.10
Average Actual Amount Loaned	12,162.90
Per Cent of Net Revenue to Actual Amount Loaned	5.94%

* 7% reserve required against deposits in country banks.

5. COMMERCIAL PAPER

STRONG, STACKPOLE & COMPANY

CONTINUOUS EXTENSION OF CREDIT LINE TO A NONBORROWING CUSTOMER WHO FINANCES IN THE COMMERCIAL PAPER MARKET[1]

For several years prior to 1931 the Kingsland National Bank of New York City had had among its customers Strong, Stackpole & Company of Nashville, Tennessee, a large wholesaler of oak, walnut, maple, and other fancy hardwoods. This company's products, which were principally used in the manufacture of furniture and for paneling and other interior decorating purposes, were known throughout the trade for their excellent quality. "S & S" branded hardwoods, which constituted approximately 50% of the company's dollar volume, were sawed for it by two manufacturing subsidiaries.

In 1923, when Strong, Stackpole & Company established a sales office and bulk breaking yard in Brooklyn, an account was opened with the Kingsland National Bank. At that time, officials of the company stated that, as in the past, it would be their policy to do current financing in the open market rather than by means of bank loans, a policy which had been adopted because of the differential in the rates of interest paid (see Exhibit 1). Nevertheless, they felt that open bank lines constituted a valuable form of insurance and requested the Kingsland National Bank to extend the company credit up to $750,000, promising adequate balances in return.

From the time this account was opened to the end of 1930, Strong, Stackpole & Company never asked for a loan from the Kingsland National Bank. The account was not an active one,

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[1] References for use in this and subsequent commercial paper cases: Greef, A. O., *The Commercial Paper House in the United States*, Chs. VI, VIII, X, XIII, and XIV; Kniffin, W. H., Jr., *Commercial Paper, Acceptances and the Analysis of Credit Statements*, second edition; Martin, B. F., "Recent Movements in the Commercial-Paper Market," *Harvard Business Review*, April, 1931, pp. 360–370. For another case, see Buckner Lumber Company, Ebersole, J. F., *op. cit.*, first edition, pp. 81–88. For a comparison of "outside" purchases of installment finance paper with commercial paper, see the cases of Madden Finance Company and Western Credit Company, *infra*.

and excellent balances were kept at all times.[1] The bank paid interest on deposits at the highest rate allowed by the New York Clearing House Association. During these years the Kingsland National Bank developed a high regard for the management of Strong, Stackpole & Company. In spite of adverse conditions in the lumber industry and, in later years, in building construction and the furniture trade, this concern had continued to make large profits. Its commercial paper always commanded a low rate, and reports from the trade were uniformly favorable.

EXHIBIT 1

Prime Four to Six Months' Commercial Paper Rates, and Rates Charged on Prime Commercial Loans to Customers in New York City*

1930	Commercial Paper	Customers' Loans
January	4¾–5%	5¼–5½%
February	4½–5	5 –5¼
March	3¾–4¾	4¾–5
April	3¾–4	4½–4¾
May	3½–4	4¼–4½
June	3¼–3¾	4 –4½
July	3 –3½	4 –4½
August	3	4 –4¼
September	3	4
October	3	3¾–4
November	2¾–3	3½–4
December	2¾–3	3½–4

* Source: *Federal Reserve Bulletin*, January, 1931, and earlier months.
Corresponding rates for the years 1925 to 1929, inclusive, may be found in the *Annual Report of the Federal Reserve Board*, 1929, pp. 93 and 95.
The subject of rates on customers' loans is treated in the case of Charles Fairbanks Company, *supra*.

In February, 1931, the bank received the 1930 statement of Strong, Stackpole & Company, shown in Exhibit 2, and the information published annually on this name by the company's paper broker, shown in Exhibit 3. A representative of the commercial paper house, which was one of the most reputable in New York, stated in conversation that his firm felt no misgivings in regard to the company and anticipated no difficulty in marketing

[1]

AVERAGE LEDGER BALANCES

1924	$109,200	1927	$120,700	1930	$115,400
1925	118,600	1928	113,300		
1926	119,600	1929	118,300		

its paper during 1931, in spite of the somewhat poorer showing made in 1930 as compared with previous years.

EXHIBIT 2

Financial Statements of Strong, Stackpole & Company, as of December 31, 1926 to 1930*

	1926	1927	1928	1929	1930
Assets					
Cash	$ 333,079	$ 363,778	$ 295,785	$ 303,637	$ 335,982
Notes Receivable	206,954	214,000	182,596	195,653	125,568
Accounts Receivable	608,619	430,672	502,977	849,120	378,555
Merchandise	1,546,956	1,271,478	2,066,690	2,137,814	2,785,737
Advances on Timber	1,091,209	1,635,480	767,820	729,129	322,114
Marketable Securities	537,617	1,006,261	1,362,912	1,037,114	1,100,660
Current Assets	$4,324,434	$4,921,669	$5,178,780	$5,252,467	$5,048,616
Land and Buildings	252,405	246,051	245,040	245,724	233,986
Investments in Subsidiaries	1,579,538	1,665,645	1,716,260	1,927,527	2,003,515
Miscellaneous Accounts Receivable	13,933	6,746	12,877	4,554	8,909
Mortgages Receivable	....	183,750	324,384	306,465	326,643
Total Assets	$6,170,310	$7,023,861	$7,477,341	$7,736,737	$7,621,669
Liabilities					
Notes Payable—Brokers	$ 675,000	$1,200,000	$1,395,000	$1,102,500	$1,140,000
Notes Payable	60,000	45,000	90,000	45,000	3,750
Accounts Payable	16,836	13,119	8,331	12,469	8,944
Accruals	79,062	17,175	....	....	....
Reserve for Taxes	66,040	49,912	35,378	54,525	6,180
Reserve for Bad Debts	71,882	67,355	81,121	99,741	112,500
Reserve for Contingencies	....	....	....	....	187,500
Current Liabilities	$ 968,820	$1,392,561	$1,609,830	$1,314,235	$1,458,874
Common Stock	3,000,000	3,000,000	3,000,000	3,000,000	3,000,000
Surplus	2,201,490	2,631,300	2,867,511	3,422,502	3,162,795
Total Liabilities	$6,170,310	$7,023,861	$7,477,341	$7,736,737	$7,621,669
Sales	....	$7,808,030	$7,361,690	$9,509,919	$6,760,812
Current Ratio	4.46–1	3.53–1	3.21–1	3.99–1	3.46–1
Net Worth—Debt	5.36–1	4.04–1	3.64–1	4.88–1	4.22–1
Net Worth—Fixed Assets	20.60–1	22.88–1	23.94–1	26.13–1	26.43–1
Merchandise—Receivables	1.89–1	1.97–1	3.01–1	2.04–1	5.52–1
Sales—Merchandise	....	6.14–1	3.56–1	4.44–1	2.42–1
Collection Period	....	30 days	34 days	40 days	27 days
Sales—Fixed Assets	....	31.73–1	30.04–1	38.70–1	28.89–1
Sales—Net Worth	....	1.38–1	1.25–1	1.48–1	1.09–1
Acid Test	1.18–1	.72–1	.60–1	1.02–1	.57–1

* Audited.

On February 23 Mr. Rand, the officer of the Kingsland National Bank who handled Strong, Stackpole & Company's account, received the following letter from Mr. D. R. Strong, president of the concern:

DEAR MR. RAND:

By this time you have had an opportunity to examine our year-end statement which, I trust, meets with your approval. You will notice that our borrowings on statement date were almost identical with those on the same date in 1929 and, in this connection, I have a suggestion which I should like to submit to you.

A few days ago one of our depository banks voluntarily raised our line of credit for the year 1931 from \$500,000 to \$750,000. I should like to have you consider this matter and see if you would approve an increase in our line from \$750,000 to \$1,000,000.

In asking for this increase, I have no idea that we shall ever use the accommodation. As you know, I consider bank lines in the nature of insurance and as a help to us in selling our paper. I do want, however, in case that conditions should arise which would make the sale of open-market paper difficult, to be sure that our banks of deposit will take care of us.

I believe that your bank, and others, have made enough profit from our account in the past to meet any request within the limits of the credit extended to us. We shall do our best to insure the continuation of such an attitude on your part.

Hoping that you will grant this increase, I remain,

Yours very truly,

D. R. Strong, President

EXHIBIT 3

Information on Strong, Stackpole & Company, Nashville, Tennessee, Lumber Wholesalers, Supplementing December 31, 1930, Statement

History.—This business was established in 1901 and is incorporated under the laws of Tennessee. The net worth in 1912 was \$375,000 and, at the end of 1930, \$6,162,795, all of this increase having come from the reinvestment of earnings of Strong, Stackpole & Company and its separately incorporated divisions.

Operating Details.—Except for sales figures for 1927 to 1930, the company continues to keep all information regarding operations confidential for trade reasons.

Operations for the Year Ended December 31, 1930.

Dividends paid—none
Doubtful accounts charged off—\$18,303; recovered—\$566
Contingent liabilities—none
Basis of merchandise valuation—lower of cost or market
Maximum open-market outstandings—\$1,705,000, April, 1930
Minimum open-market outstandings—\$1,002,500, January, 1930
Total bank lines reported—\$4,000,000, all open on statement date

It is reported that the company continued to operate on a profitable basis, as indicated by the reserve set up for Federal taxes. However, it sustained some loss in inventorying its marketable securities at the lower of cost or market as of December 31, and in addition set up a special reserve for contingencies amounting to \$187,500. As a result, the surplus account shows a shrinkage for the year.

Marketable Securities.—This item is composed of bonds and stocks listed on the major exchanges and owned free and clear. The securities in each case are valued at the lower of cost or market.

Advances on Timber.—This item represents timber purchased for subsidiary concerns. Strong, Stackpole & Company holds title and, in addition, has a guarantee of reimbursement for any losses. Advances are repaid out of lumber shipments to Strong, Stackpole & Company.

Mortgages Receivable.—This item represents funds advanced to the company's two manufacturing subsidiaries, secured by first mortgages on their plants.

EXHIBIT 3. (*Continued*)

Subsidiary Companies.—Of the $2,003,515 item, investments in subsidiaries, $1,920,800 represents 9,800 of the outstanding 10,000 common shares of the Stackpole Hardwood Company. The remaining $82,715 is made up of the entire common stock of the Clymer Lumber Company.

The December 31, 1930, statement of the Stackpole Hardwood Company showed current assets of $1,395,000 to pay current liabilities of $430,000, of which $320,000 was due to Strong, Stackpole & Company. Surplus showed an increase of over $40,000 for the year, a condition which indicates that operations were conducted on the usual profitable basis.

The Clymer Lumber Company is being liquidated rapidly through the sale of its timber, practically all of which has been cut.

The subsidiaries do no borrowing in their own names except for occasional small amounts by the Stackpole Hardwood Company for payroll purposes.

Receivables.—The collection period was 27 days in 1930, compared with 40 days in 1929. Bad debt losses during the past three years have amounted to $57,348 on sales of $23,632,421.

Nature of Business.—Strong, Stackpole & Company operates as a wholesaler of hardwood lumber, a considerable part of which is manufactured by its two subsidiary mill companies. Executive offices are located in Nashville, with sales branches in Brooklyn, New York, and Grand Rapids, Michigan.

Why did Strong, Stackpole & Company request an increase in its unused line of credit in February, 1931?

Should the Kingsland National Bank have granted this request?

Should the decision be different if Strong, Stackpole & Company intended to use its full line of $1,000,000 sometime during the year 1931?

What saving in interest rate can this company obtain by using commercial paper sales in lieu of bank customers' loans as a source of credit funds?

Estimate the value to the commercial paper borrower of having a full bank credit line coverage when offering such paper for sale.

What extra costs (figured as a rate on its borrowed funds) are incurred by this company in obtaining credit lines (and maintaining bank balances) to insure the redemption of its own float of commercial paper?[1]

Formulate a principle, or rule of action, to be followed for sound bank administration, as to (*a*) the maximum amount of credit lines that should be granted and outstanding for any particular bank, and (*b*) the balances to be expected or required of a customer having an unused credit line.

[1] For an example of interest rates paid upon checking accounts of corporations by banks in clearing house cities, consult Potter Trust Company, *infra.*

HILL NATIONAL BANK

APPRAISAL OF COMMERCIAL PAPER RISK RELATIVE TO RATE

On September 30, 1930, the president of the Hill National Bank of Chicago advised Mr. David Kremer, the vice president who had charge of purchasing commercial paper, that on the following day the bank would place $100,000 at his disposal for six months. As was customary, the selection of the paper was to be left entirely to Mr. Kremer's discretion.

Mr. Kremer immediately telephoned Gibbons & Company, a prominent firm of Chicago paper brokers, for their list of offerings, and chose from this list the following names for further consideration:

Name	Amount Available	Yield	Maturity
A. C. Platt & Company	$ 95,000	3½%	6 months
St. Charles Shoe Company	72,500	3½%	6 "
Sunnydell Grocery Stores, Incorporated	55,000	3¼%	6 "
P. R. O'Toole & Sons	110,000	3¼%	6 "
Shotten Furnace and Equipment Corporation	50,000	3%	6 "
Mark Dinsmore & Company	62,500	3%	6 "

He instructed Gibbons & Company to send him financial statements and the customary information sheets for these six concerns, and received the material shown in Exhibits 1 to 12. Ratios were then computed, as shown in Exhibit 13.

Which "names" yield more and which less, relative to risk?

In the absence of complete or of audited data, should banks rely upon the reputation of the broker selling commercial paper?

How much dependence should one place upon ratings made on these companies by Dun and Bradstreet?

Are the dates of offering and of maturity significant in buying this commercial paper?

EXHIBIT 1

Financial Statements of A. C. Platt & Company of Lincoln, New Hampshire, Manufacturers of Woolens, as of December 31, 1927 to 1929

	1927		1928		1929	
Current Assets						
Cash		$ 130,018		$ 120,049		$ 144,006
Accounts Receivable		535,730		408,594		397,809
Inventories—Finished Goods	$137,388		$141,398		$138,271	
Raw Materials	361,437		381,888		317,379	
Supplies	6,858	505,683	7,881	531,167	10,173	465,823
Total Current Assets		$1,171,431		$1,059,810		$1,007,638
Cash Value of Life Insurance		58,525		72,229		85,950
Notes Receivable—Employees'		25,425		20,325		20,325
Prepayments						
Insurance	$ 3,049		$ 3,014		$ 2,280	
Interest	3,916		7,464		5,431	
Miscellaneous	3,412	10,377	1,975	12,453	2,871	10,582
Real Estate, Buildings, and Machinery						
Properties at Cost	$394,278		$544,902		$570,960	
Less Reserve for Depreciation	170,640	223,638	186,748	358,154	205,861	365,099
Trade-marks						825
Total Assets		$1,489,396		$1,522,971		$1,490,419
Current Liabilities						
Notes Payable—Brokers		262,500		412,500		375,000
Accounts Payable		18,205		7,160		120,807
Provision for Federal Income Tax		36,750		4,350		
Total Current Liabilities		$ 317,455		$ 424,010		$ 495,807
Capital and Surplus						
Preferred Stock	$492,000		$482,700		$476,700	
Common Stock	60,000		60,000		60,000	
Surplus	619,941	1,171,941	556,261	1,098,961	457,912	994,612
Total Liabilities		$1,489,396		$1,522,971		$1,490,419

EXHIBIT 2

Confidential
The enclosed information is given for your own use and without responsibility to us.
Gibbons & Company

Information on A. C. Platt & Company
Lincoln, New Hampshire
Manufacturers of Woolens
Supplementing December 31, 1929, Statement

1. History and Personnel.—This business was established in 1876 and incorporated under the laws of New Hampshire in 1885 by Mr. A. C. Platt. The present president, Mr. Gordon D. Grimes, has been the principal factor in the control of the company since 1913.

2. Operating Details.

	1927	1928	1929
Sales	$3,222,544	$2,187,882	$2,034,684
Net Profits	235,362	31,668	66,379(d)
Dividends, Preferred	34,440	33,930	33,632
Common	60,000	60,000	None

(d) Deficit.

3. Operations for the Year Ended December 31, 1929.

Reconciliation of surplus—add difference in price on preferred stock purchased—$1,125, and adjustment of 1928 taxes—$537
Contingent liabilities—none
Depreciation charged off—$19,397
Doubtful accounts charged off—$535
Maximum open-market outstandings—$500,000, July 31 to August 31, 1929
Minimum open-market outstandings—$275,000, October 31, 1929
Bank accounts—"A" Trust Company, Lincoln, New Hampshire
"B" Trust and Savings Bank, Boston, Massachusetts
"C" National Bank, Boston, Massachusetts
Total Bank Lines—$525,000

4. Fixed Assets.—During the year the company spent $25,000 on improvements and additions to plant and equipment, which completes a three-year plan for the expansion of fixed assets.

5. Nature of Business.—The company manufactures a good quality of woolen and worsted cloth for use in both men's and women's clothing. Manufacturing is largely on special order. Its customers include some of the most reputable jobbing houses in the country, which in turn sell to tailors and clothing manufacturers. A sales office is maintained in Boston, Massachusetts.

A. C. Platt & Company is given a Dun's Rating AA1. $500,000 to $750,000. Highest Credit.

EXHIBIT 3

Financial Statements of the St. Charles Shoe Company, St. Charles, Missouri, Manufacturers of Men's Shoes, as of December 31, 1927 to 1929

	1927	1928	1929
Cash	$ 51,865	$ 100,697	$ 92,943
Accounts Receivable (Net)	212,119	211,780	167,452
Notes Receivable	42,007	49,108	44,443
Current Investments	289,791	349,713	296,814
Inventory	171,475	139,871	480,452
Prepaid Items	6,565	3,079	....
Quick Assets	$ 773,822	$ 854,248	$1,082,104
Stock in Other Companies	11,288	11,288	....
Treasury Stock	145,623	162,073	162,946
Plant, Machinery, and Equipment (Less Depreciation)	88,432	77,050	103,148
Total Assets	$1,019,165	$1,104,659	$1,348,198
Notes Payable	$ 183,750	$ 253,800	$ 332,500
Accounts Payable (Net)	11,770	9,440	80,727
Accrued Items	6,563	10,500	43,988
Quick Debt	$ 202,083	$ 273,740	$ 457,215
Reserve for Taxes	4,956	....	....
Capital Stock (Common and Preferred)	304,325	304,325	304,325
Surplus	507,801	526,594	586,658
Total Liabilities	$1,019,165	$1,104,659	$1,348,198

EXHIBIT 4

Confidential
The enclosed information is given for your own use and without responsibility to us.
Gibbons & Company

Information on the St. Charles Shoe Company
St. Charles, Missouri
Manufacturers of Men's Shoes
Supplementing December 31, 1929, Statement

1. History and Personnel.—This concern was incorporated in May, 1914, under Missouri laws. Mr. Alfred Parke, president, has devoted his full attention to the business since it was founded.

2. Operating Details.

	1927	1928	1929
Sales	$1,483,149	$1,396,705	$2,665,294
Net Profits	39,266	32,627	131,843
Dividends, Preferred	11,980	10,934	10,565
Common	3,465	3,465	61,215

3. Operations for the Year Ended December 31, 1929.
Reconciliation of surplus—add profits and deduct dividends
Contingent liabilities—none
Depreciation charged off—$18,643
Lasts and patterns charged off—$41,288
Doubtful accounts charged off—$23,189
Maximum open-market outstandings—$446,250, March 1, 1929
Minimum open-market outstandings—$175,000, August 1 to November 30, 1929
Bank accounts—"A" National Bank, St. Louis, Missouri
"B" Bank & Trust Company, St. Louis, Missouri
"C" National Bank, Chicago, Illinois

4. Current Investments.—Of this item $241,970 represents listed securities, the market value of which was $240,594 on December 31, 1929. The balance of the investment item consists principally of $36,250 common stock in Goldthwaite & Company, Incorporated, of Chicago, manufacturers of rubber footwear.

5. Nature of Business.—The company produces entirely men's medium-grade shoes. About 85% of its product is sold to the Norton Shoe Company of St. Louis, which operates a chain of retail stores in the Middle West. It is necessary to keep a considerable stock of finished goods on hand at all times, available for shipping to the different stores as called for. Payments are received from the Norton Shoe Company twice each month. The December 31, 1929, statement of the Norton Shoe Company shows Current Assets of $3,490,000 to pay Current Liabilities of $977,000, with no notes payable for borrowed money. Net Worth was over $4,098,000.

Prior to November, 1928, when the company entered into its agreement with the Norton Shoe Company, its shoes were sold direct to the retail trade and enjoyed a high reputation for quality.

The St. Charles Shoe Company is given a Dun's Rating AAl. $500,000 to $750,000. Highest Credit.

EXHIBIT 5

Financial Statements of the Sunnydell Grocery Stores, Incorporated, Los Angeles, California, Chain Grocery Stores, as of December 31, 1927 to 1929

	1927		1928		1929	
Current Assets						
Cash	$203,579		$ 136,153		$ 236,822	
Notes Receivable	173,962		5,338		5,610	
Accounts Receivable			223,744		264,429	
Inventories	948,531	$1,326,072	1,264,786		1,167,887	
Cash Surrender Value Life Insurance			11,756	$1,641,777	13,159	$1,687,907
Deferred Charges		10,142		19,669		19,295
Investments						
Subsidiary Company, Book Value, and Advances			$ 114,575		$ 116,988	
Other Companies		144,946	54,621		93,173	
Due from Individuals			37,647	206,843	21,690	
Bonds and Mortgages					778	232,629
Fixed and Capital Assets						
Land, Buildings, and Equipment	$668,571		$ 763,991		$ 790,552	
Less Reserve for Depreciation	178,561	490,010	168,283	595,708	139,827	650,725
Goodwill		100,000				
Total Assets		$2,071,170		$2,463,997		$2,590,556
Current Liabilities						
Notes Payable	$275,000		$ 400,000		$ 267,500	
Accounts Payable	58,665		130,655		125,605	
Dividends Payable	77,936	411,601	74,801		110,290	
Federal Income Tax Reserve			22,643	628,099	29,137	532,532
Deferred Liabilities						
Mortgages Payable	$ 57,000		$ 57,000		$ 59,400	
Reserve for Fire Insurance	47,705*	104,705	25,455	82,455	30,570	89,970
Capital and Surplus						
"Minority Interest"		59,385		186,962		234,449
Preferred Stock	$209,500		$ 208,000		$ 242,500	
Common Stock	869,528		861,267		1,287,800	
Surplus	416,451		497,214		203,305	
Net Worth		1,495,479		1,566,481		1,733,605
Total Liabilities		$2,071,170		$2,463,997		$2,590,556

* Including Federal income tax reserve.

EXHIBIT 6

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Information on the Sunnydell Grocery Stores, Incorporated
Los Angeles, California
Chain Grocery Stores
Supplementing December 31, 1929. Statement

1. History and Personnel.—This company was organized in 1918 and incorporated under California laws. It originally operated as a wholesale grocery and, in 1922, began a chain of retail stores. The officers of the company give their active attention to the business.

2. Operating Details.

	1927	1928	1929
Sales	$8,140,035	$9,188,061	$9,515,520
Net Profits	177,913	178,870	250,885
Dividends, Preferred	16,789	11,424	13,650
Common, Cash	69,557	68,883	103,024
Common, Stock	....	....	430,000

Records going back to December 31, 1922, show that during this time the company has operated at a profit every year. The year ended December 31, 1929, was the largest in the history of the company in respect to both sales and earnings.

3. Operations for the Year Ended December 31, 1929.

Reconciliation of surplus—add surplus arising from appraisal—$2,714; deduct premium on stock purchased—$834.
Contingent liabilities—none
Depreciation charged off—$36,478
Doubtful accounts charged off—$15,799
Maximum open-market outstandings—$350,000, January 15 to April 30, 1929
Minimum open-market outstandings—$135,000, November 30, 1929
Bank accounts—"A" National Bank, Los Angeles, California
"B" National Bank, Los Angeles, California
"C" National Bank, Pasadena, California
"D" Trust Company, Hollywood, California
"E" National Bank, Long Beach, California
Total bank lines—$400,000

4. Investments.—The item, Investments in Other Companies, is almost entirely made up of a common stock interest in George Crimmins, Incorporated, a chain store concern which operates in San Diego, California.

5. Mortgages Payable.—These mortgages have no fixed maturity dates and are not to be considered as a current liability.

6. "Minority Interest."—This item represents certificates which have been issued to Remington Brothers and Mitchell, Incorporated, and Adams & Company, two meat chains which operate markets in conjunction with the larger "Sunnydell Stores." The certificates are issued according to the amount of assets turned over to the Sunnydell Company, subsidiary of the Sunnydell Grocery Stores, Incorporated, the balance of the capital required by the markets being supplied by the Sunnydell Company.

EXHIBIT 6. (*Continued*)

7. Sunnydell Company.—This company is a wholly owned subsidiary of of the Sunnydell Grocery Stores, Incorporated. Its sole purpose is to act as a holding company for Remington Brothers and Mitchell, Incorporated, and Adams & Company.

8. Nature of Business.—The company conducts a chain grocery store business. The headquarters are in Los Angeles, California, with branches in Pasadena, Hollywood, Beverly Hills, Glendale, Long Beach, and San Pedro, California. The stores in the chain, which number about 210, are called the "Sunnydell Stores," and are owned outright by the Sunnydell Grocery Stores, Incorporated. In addition, meat markets are operated as integral parts of 31 of the stores in accordance with the plan outlined above.

The Sunnydell Grocery Stores, Incorporated, is given a Dun's Rating AaAl. Over $1,000,000. Highest Credit.

EXHIBIT 7

Financial Statements of P. R. O'Toole & Sons, St. Paul, Minnesota
Wholesale and Retail Hardware Dealers, as of
January 31, 1928 to 1930

	1928	1929	1930
Cash on Hand and in Bank	$ 28,548	$ 30,517	$ 4,293
Customers' Accounts Receivable	321,555	340,437	263,510
Customers' Notes Receivable	47,993	46,598	53,680
Merchandise Inventory	675,420	727,696	763,596
Prepaid Insurance	....	....	7,365
Total Quick Assets	$1,073,516	$1,145,248	$1,092,444
Land, Buildings, and Machinery	791,960	795,512	799,182
Automobiles and Delivery Equipment	18,222	13,430	16,326
Deferred Assets	6,801	....	5,743
Prepaid Insurance	4,464	5,589	....
Total Assets	$1,894,963	$1,959,779	$1,913,695
Notes Payable, Banks and Brokers	$ 285,000	$ 330,000	$ 150,000
Other Notes Payable	....	2,392	17,390
Accounts Payable to Officers and Directors	25,464	13,382	31,719
Total Quick Liabilities	$ 310,464	$ 345,774	$ 199,109
Reserve for Depreciation	109,537	99,861	120,846
Preferred Stock	300,000	300,000	300,000
Common Stock	450,000	450,000	450,000
Surplus	724,962	764,144	843,740
Total Liabilities	$1,894,963	$1,959,779	$1,913,695

EXHIBIT 8

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Gibbons & Company

Information on P. R. O'Toole & Sons, St. Paul, Minnesota
Wholesale and Retail Hardware Dealers
Supplementing January 31, 1930, Statement

1. History and Personnel.—This concern was founded in 1890 by Mr. P. R. O'Toole, who still occupies the position of president, although Mr. B. P. Mayhew and Mr. Dennis O'Toole are in active charge of the company's affairs at the present time. Mr. P. R. O'Toole is a director of both of the company's depository banks.

2. Operating Details.

	1928	1929	1930
Sales	$2,554,703	$2,488,326	$2,744,475
Net Profits	91,084	146,331	208,284
Dividends, Preferred	21,000	21,000	21,000
Common	90,000	90,000	90,000

Total net profits of the company for 10 years ended January 31, 1930, amounted to $1,372,479, the profits for the last fiscal year being the largest in the company's history.

3. Operations for the Year Ended January 31, 1930.

Reconciliation of surplus—deduct previous year's taxes of $17,688
Contingent liabilities—none
Depreciation charged off—$22,857
Doubtful accounts charged off—$35,436
Maximum open-market outstandings—$300,000, February 1 to March 30, 1929
Minimum open-market outstandings—$65,000, May 1 to July 31, 1929
Bank accounts—"A" National Bank, St. Paul, Minnesota
"B" National Bank, St. Paul, Minnesota
Total bank lines—$350,000

The financial statements of this company are not audited, but are signed by officers.

4. Nature of Business.—The company operates a wholesale hardware business and two retail stores, which are, however, of minor importance in comparison with the wholesale end. Lines include a considerable amount of heavy builders' hardware as well as light hardware, electrical supplies, and sporting goods. Sales are made on terms of 2%, 10 days, net 30 and 60 days.

P. R. O'Toole & Sons is given a Dun's Rating A+A1. $750,000 to $1,000,000. Highest Credit.

EXHIBIT 9

Financial Statements of the Shotten Furnace and Equipment Corporation, Chicago, Illinois, Manufacturers of Furnaces and Heating Systems, as of December 31, 1927 to 1929

	1927		1928		1929	
Current Assets						
Cash in Bank	$ 348,846		$ 385,855		$ 421,476	
Accounts Receivable	852,572		1,136,743		1,146,882	
Bills Receivable	117,800		105,627		232,152	
Installations in Process	900,023		986,492		1,083,380	
Inventories	1,829,736		1,735 547		1,947,404	
Liquid Investments	4,365		165,387		85,608	
	$4,053 342		$4,515,651		$4,916,902	
Less Cash Received on Installations	260,922	$3,792,420	328,102	$4,187,549	404,168	$4,512,734
Fixed and Capital Assets						
Real Estate, Buildings, and Equipment	$2,920,704		$3,047,509		$3,291,308	
Less Depreciation	1,209,285	1,711,419	1,358,069	1,689,440	1,511,899	1,779,409
Investments in Affiliated Companies		407,213		411,485		402,170
Goodwill and Patents		413,494		408,750		404,472
Deferred Assets		54,512		24,844		6,792
Total Assets		$6,379,058		$6,722,068		$7,105,577
Current Liabilities						
Accounts Payable	$ 141,140		$ 198,829		$ 186,646	
Notes Payable					100,000	
Preferred Dividend Payable January 1	9,720		9,720			
Due Affiliated Companies	82,222	233,082	27,264	235,813	166,385	453,031
Reserves						
Federal Taxes	$ 112,240		$ 81,297		$ 87,492	
Local and State Taxes	12,192		15,770		19,770	
Contingencies and Others	491,437	615,869	636,220*	733,287	544,850	652,112
Preferred Stock		600,000		600,000		
Common Stock		3,600,000		3,600,000		4,150,000
Surplus		1,330,107		1,552,968		1,850,434
Total Liabilities		$6,379,058		$6,722,068		$7,105,577

* Including preferred stock sinking fund.

EXHIBIT 10

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Gibbons & Company

Information on the Shotten Furnace and Equipment Corporation, Chicago, Illinois
Manufacturers of Furnaces and Heating Systems
Supplementing December 31, 1929, Statement

1. History and Personnel.—This company was established in 1903 and incorporated under Delaware laws in 1905. The active management is chiefly in the hands of Mr. James B. Hurst. The officers and directors of the company are for the most part prominent in industrial and financial affairs in Chicago.

2. Operating Details.

	1927	1928	1929
Sales	$9,298,695	$9,727,724	$10,042,846
Net Profits	471,136	603,782	700,004
Dividends	....	Not reported	....

3. Operations for the Year Ended December 31, 1929.
Contingent liabilities—$48,000
Depreciation charged off—$153,831
Doubtful accounts charged off—$28,734
Maximum open-market outstandings—$65,000, December 31, 1929
Minimum open-market outstandings—none, January 15 to April 31 and August 1 to December 1, 1929
Bank accounts—"A" National Bank, New York, New York
"B" Trust Company, Chicago, Illinois
"C" National Bank, Chicago, Illinois
"D" Trust and Savings Bank, Cleveland, Ohio
"E" National Bank, St. Louis, Missouri
Total bank lines—$800,000

4. Capital Stock.—During 1929 the entire outstanding preferred stock was called and retired. The $550,000 increase in common stock resulted in large part from a stock dividend.

5. Investments in Affiliated Companies.—This item represents what is reported to be a controlling interest in the Andrew J. Hansen Company, Incorporated, manufacturers of cooling and humidifying systems for office buildings. The Andrew J. Hansen Company, Incorporated, which is located in St. Louis, showed on its December 31, 1929, statement current assets of over $600,000, current liabilities of slightly over $200,000, and bank debt of $75,000.

6. Nature of Business.—The company manufactures and installs furnaces and heating systems used in office buildings, apartment houses, schools, public buildings, etc. Its line of furnaces for private homes is becoming an increasingly important part of its business. Products also include piping, valves, etc.

In addition to the main plant in Chicago, the company has factories in Newark, New Jersey, and Cleveland, Ohio.

Its products are widely and favorably known throughout the building trades.

The Shotten Furnace and Equipment Corporation is given a Dun's Rating AaAl. Over $1,000,000. Highest Credit.

EXHIBIT 11

Financial Statements of Mark Dinsmore & Company, Brooklyn, New York, Manufacturers of Women's High-grade Shoes, as of December 31, 1927 to 1929

	1927		1928		1929	
Cash		$ 730,238		$ 405,250		$ 236,507
Stocks and Bonds		362,444		367,566		223,050
Accounts Receivable	$ 367,704		$ 364,930		$297,820	
Less Reserve for Discount	18,385	349,319	16,770	348,160	13,676	284,144
Notes Receivable		8,000		4,000		
Mortgages Receivable				11,832		15,273
Merchandise Inventory		623,952		605,486		1,122,532
Total Current Assets		$2,073,953		$1,742,294		$1,881,506
Real Estate, Machinery, and Equipment		39,653		31,820		116,628
Total Assets		$2,113,606		$1,774,114		$1,998,134
Notes Payable		$ 120,000				$ 240,000
Accounts Payable						182,394
Reserve for Taxes		40,000		$ 60,000		40,000
Total Current Liabilities		$ 160,000		$ 60,000		$ 462,394
Capital Stock	$1,600,000		$1,120,000		$800,000	
Surplus	353,606	1,953,606	594,114	1,714,114	735,740	1,535,740
Total Liabilities		$2,113,606		$1,774,114		$1,998,134

EXHIBIT 12

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Gibbons & Company

Information on Mark Dinsmore & Company, Brooklyn, New York
Manufacturers of Women's High-grade Shoes
Supplementing December 31, 1929, Statement

1. History and Personnel.—This business was organized many years ago as a proprietorship and was incorporated under New York laws in 1865. Since its inception the company has been in the hands of the Dinsmore family, the present officers including E. C. B. Dinsmore, president, and N. R. Dinsmore, secretary-treasurer.

2. Operating Details—Not Reported.

	1927	1928	1929
Sales (Approximate)................	$3,200,000	$4,000,000	$3,600,000
Net Profits (Approximate)...........	300,000	600,000	350,000

It is understood that the company pays liberal officers' salaries.

3. Operations for the Year Ended December 31, 1929.

Dividends paid—Approximately $50,000
Contingent liabilities—Approximately $300,000
Maximum open-market outstandings—December 15 to December 31, 1929, $235,000
Minimum open-market outstandings—January 1 to December 15, 1929, none
Bank accounts—"A" Trust Company, Brooklyn, New York
"B" Bank & Trust Company, Brooklyn, New York
"C" National Bank, New York, New York
"D" Commercial & Savings Bank, New York, New York
Total bank lines—$475,000

The financial statements of this company are not audited, but are signed by officers.

4. Stocks and Bonds.—It is stated that $83,765 of this amount represents unlisted securities of other shoe and leather companies. The remaining $139,285 is composed of stocks and bonds listed on the New York Stock Exchange.

5. Capital Stock.—During 1929 the company retired $320,000 of its outstanding capital stock, which is all of one class and is closely held by the Dinsmore family. It is stated that the company plans to retire no more capital stock.

6. Fixed Assets.—The increase in fixed assets on the December 31, 1929, statement represents additions to the company's plant which, when completed, will result in a substantial increase in manufacturing capacity.

7. Nature of Business.—The company manufactures women's high-grade slippers and shoes. Production is on special order from exclusive retail shops and important theatrical companies. Inventory consists mainly of raw skins which the company purchases itself and has tanned on contract by independent concerns.

Mark Dinsmore & Company is given a Dun's Rating: AaAl. Over $1,000,000. Highest Credit.

EXHIBIT 13

Ratios for the Six Companies Considered, 1927 to 1929, Inclusive

	1927	1928	1929	1927	1928	1929
	A. C. Platt & Company			St. Charles Shoe Company		
Current Ratio	3.69–1	2.49–1	2.03–1	3.82–1	3.12–1	2.36–1
Net Worth—Debt	3.69–1	2.59–1	2.00–1	3.29–1	2.44–1	1.59–1
Net Worth—Fixed Assets	5.24–1	3.06–1	2.72–1	7.53–1	8.68–1	7.05–1
Merchandise—Receivables	.94–1	1.29–1	1.17–1	.67–1	.53–1	2.26–1
Sales—Merchandise	6.37–1	4.11–1	4.36–1	8.64–1	9.98–1	5.54–1
Collection Period	60 days	68 days	71 days	62 days	68 days	29 days
Sales—Fixed Assets	14.40–1	6.10–1	5.57–1	16.77–1	18.12–1	25.83–1
Sales—Net Worth	2.74–1	1.99–1	2.04–1	2.22–1	2.08–1	3.66–1
Profit on Sales	7.30 %	1.44 %	....	2.64 %	2.33 %	4.94 %
Profit on Net Worth	20.08 %	2.88 %	.....	5.89 %	4.87 %	18.10 %
Acid Test	2.09–1	1.24–1	1.09–1	1.51–1	1.32–1	.66–1
	Sunnydell Grocery Stores, Incorporated			P. R. O'Toole & Sons		
Current Ratio	3.22–1	2.61–1	3.16–1	3.45–1	3.31–1	5.48–1
Net Worth—Debt	2.64–1	1.79–1	2.09–1	4.75–1	4.37–1	8.00–1
Net Worth—Fixed Assets	2.84–1	2.62–1	2.66–1	2.16–1	2.17–1	2.34–1
Merchandise—Receivables	5.45–1	5.52–1	4.32–1	1.82–1	1.88–1	2.40–1
Sales—Merchandise	8.58–1	7.26–1	8.14–1	3.78–1	3.41–1	3.59–1
Collection Period	7 days	9 days	10 days	52 days	56 days	42 days
Sales—Fixed Assets	16.61–1	15.42–1	14.62–1	3.74–1	3.57–1	4.04–1
Sales—Net Worth	5.83–1	5.86–1	5.48–1	1.73–1	1.64–1	1.72–1
Profit on Sales	2.18 %	1.94 %	2.63 %	3.56 %	5.88 %	7.58 %
Profit on Net Worth	12.74 %	11.41 %	14.47 %	6.17 %	9.66 %	13.06 %
Acid Test	.91–1	.58–1	.95–1	1.28–1	1.20–1	1.61–1
	Shotten Furnace & Equipment Corporation			Mark Dinsmore & Company		
Current Ratio	16.27–1	17.75–1	9.96–1	12.96–1	29.03–1	4.06–1
Net Worth—Debt	21.95–1	22.66–1	12.35–1	12.21–1	28.56–1	3.32–1
Net Worth—Fixed Assets	2.98–1	3.16–1	3.14–1	49.26–1	53.86–1	13.16–1
Merchandise—Receivables	2.54–1	1.92–1	1.90–1	1.74–1	1.71–1	3.96–1
Sales—Merchandise	3.76–1	4.06–1	3.82–1	....	....	....
Collection Period	38 days	46 days	50 days	....	....	....
Sales—Fixed Assets	5.43–1	5.75–1	5.64–1	....	....	....
Sales—Net Worth	1.81–1	1.82–1	1.79–1	....	....	....
Profit on Sales	5.06 %	6.20 %	6.97 %	....	....	....
Profit on Net Worth	9.20 %	11.29 %	12.50 %	....	....	....
Acid Test	5.65–1	6.90–1	3.97–1	6.79–1	12.62–1	1.12–1

6. TRADE ACCEPTANCES

DEL MAR PRINTING COMPANY

DESIRABILITY OF SUBSTITUTING TRADE ACCEPTANCES FOR OPEN ACCOUNTS[1]

The Del Mar Printing Company, located in Oakland, California, manufactured picture postcards and greeting cards for Christmas and other occasions. Postcards, which made up about two-thirds of the company's dollar sales, were stocked by small news stands, drug stores, and cigar stores, whereas greeting cards were sold principally to medium-size and large-size stationers.

When the company was organized in 1908, it secured its first bank credit from the Elwood National Bank of Oakland, borrowing $7,500 on its unsecured note. The company's sales grew and its line at the Elwood National Bank was increased until for the year 1920 it amounted to $25,000, which accommodation was extended thereafter up to and including 1924. The bank's experience with the company's account was satisfactory,[2] and Mr. Alexander Markham, the president of the company since its organization, was known to the officers of the Elwood National Bank as honest and industrious.

During 1917 Mr. Markham became interested in the movement which was then in progress to bring about the substitution of trade acceptances for open accounts. In February of that year he called on Mr. Hartley, the president of the Elwood National Bank, to inquire if the bank then believed that it would

[1] See Lincoln, E. E., *Applied Business Finance*, fourth edition, pp. 455–479; Mathewson, Park, *Acceptances: Trade and Bankers'*.

Year	Average Loan	Average Ledger Balance	Number of Months Out of Debt
1919	$ 9,400	$2,450	1
1920	14,750	6,300	0
1921	12,800	6,200	1
1922	13,200	5,800	1
1923	15,100	6,200	0

be desirable for him to inaugurate the use of the trade acceptance in his business. He told Mr. Hartley that the company had many slow accounts on its books, and that this situation seemed to be inevitable under the open account system because of the class of trade to which the company sold. Terms on both postcards and greeting cards were 2% 15 days, net 90 days after the first of the month following shipment. It was Mr. Markham's experience, however, that the cash discount was taken on approximately 15% only of sales, and that fully half of the smaller customers allowed their accounts to run six months or longer. He ascribed this to the fact that postcards often remained in a retailer's racks for a year or more, and that businesses having small capital and existing largely from hand-to-mouth, as was the case with most concerns selling postcards, were prone to let all but their most pressing obligations go until they found it entirely convenient to make payment, or until they wished to renew their stocks of the same merchandise.

Mr. Markham assured Mr. Hartley that the company made a careful investigation of every retailer's credit standing before it sold him goods, and stated that the company's bad debt losses were moderate considering the type of customers with whom it dealt. Consequently, he was considering trade acceptances not as a means of strengthening doubtful accounts, but merely as a collection device to speed up the turnover of receivables. He believed that if trade acceptances were drawn payable 120 days from date of invoice, the company would be able to persuade its smaller customers to sign them because of the apparent lengthening of the terms allowed, and because there were comparatively few other postcard manufacturers in the immediate vicinity from whom they could buy. He felt also that if the company made it a rule not to renew these acceptances, its collection period would be shortened from 125 days, which had been the average from 1912 to 1916, inclusive, to approximately 100 days, after allowance for customers who would continue to take their cash discounts. Finally, Mr. Markham stated that the Del Mar Printing Company needed more credit than the $15,000 line which the Elwood National Bank was then extending, and asked Mr. Hartley whether the bank would be more willing to grant this extension of credit in the form of discounting trade acceptances.

Mr. Hartley replied that any device which might serve to shorten the company's average collection period would be looked

upon with favor by the bank. At the same time, he told Mr. Markham that the Elwood National Bank did not wish to discount acceptances if that method of financing were adopted by the company. Mr. Hartley explained that, in his opinion, the trade acceptance was merely a method of handling collections and did not improve the ultimate security of the receivables, as Mr. Markham himself had admitted. For that reason, Mr. Hartley did not feel that there was any good reason for granting a customer a larger line of credit on acceptances than on single-name paper. He stated that the Elwood National Bank stood ready to increase the company's unsecured line whenever the company's statements and condition showed that such action would be justified. In the meantime, however, he declined to make advances against acceptances which represented receivables of slow-paying customers. He felt that since these acceptances and the collections thereon would come into the bank in small, odd amounts, and would require much expensive clerical work without the compensation of a higher rate, they would be less desirable than the company's own notes even if the bank undertook the difficult task of satisfying itself in regard to the credit standing of each acceptor.

Shortly after this interview, the Elwood National Bank learned that the Del Mar Printing Company had begun the use of trade acceptances and had arranged with the Montgomery National Bank of San Francisco to discount selected acceptances up to a total amount of $25,000. Although the Elwood National Bank feared that this plan might result in excessive indebtedness, the company's next statement gave no evidence of an unsatisfactory situation, and relations with the company continued as before.

In the summer of 1919 Mr. Markham again called on the Elwood National Bank, requesting that a substantial increase be made in his company's credit line on the basis of the June 30, 1919, statement, shown in Exhibit 1. A line of $25,000 was granted at that time. During the following spring Mr. Hartley learned that the company had made application for a second unsecured line at the Presidio Trust Company of San Francisco. This request had been denied, but the Presidio Trust Company had agreed to discount trade acceptances.

During the years 1920 to 1923, inclusive, the Elwood National Bank took no adverse action on the company's account, and was aware that the company's relations with the Montgomery National Bank and the Presidio Trust Company had remained substantially

EXHIBIT 1

Financial Statements of the Del Mar Printing Company, as of June 30, 1919, and December 31, 1920 to 1923*

	June 30, 1919	December 31, 1920	December 31, 1921	December 31, 1922	December 31, 1923
Assets					
Cash	$ 7,497	$ 15,986	$ 36,869	$ 22,631	$ 17,384
Notes Receivable—Customers	9,750	11,250	10,130	20,618	27,492
Accounts and Acceptances Receivable—Customers	112,264	104,387	116,874	107,745	115,367
Merchandise	51,386	56,123	61,511	60,619	68,625
Government Securities	3,000	....	1,253	....	....
Current Assets	$183,897	$187,746	$226,637	$211,613	$228,868
Land, Buildings, and Machinery	89,491	84,014	85,125	71,384	70,367
Prepayments	....	4,736	....	8,375	5,891
Miscellaneous Notes and Accounts	3,026	15,621	2,979	....	13,510
Plates, Dies, Etc.	10,000	5,750	2,885	1,000	....
Total Assets	$286,414	$297,867	$317,626	$292,372	$318,636
Liabilities					
Notes Payable—Banks	$ 13,200	$ 25,000	$ 12,500	$ 18,750	$ 12,500
Notes Payable—Merchandise	28,120	25,488	54,615	34,122	40,264
Accounts Payable	14,382	33,507	29,271	30,748	28,736
Notes Payable—Officers and Others	21,573	27,877	39,752	20,763	19,125
Accounts	......	2,626	....	637	1,116
Current Liabilities	$ 77,275	$114,498	$136,138	$105,020	$101,741
Mortgage	22,500	22,500	22,500	22,500	41,250
Common Stock	81,250	87,500	87,500	87,500	87,500
Surplus	105,389	73,369	71,488	77,352	88,145
Total Liabilities	$286,414	$297,867	$317,626	$292,372	$318,636
Contingent Liability a/c Acceptances Discounted	$ 21,370	$ 54,000	$ 47,385	$ 46,250	$ 58,875
Sales	....	393,764	431,609	423,883	509,485
Net Profits	....	13,986	2,263	5,876	10,762
Dividends	....	....	....	....	....
Current Ratio	2.37–1	1.63–1	1.66–1	2.01–1	2.24–1
Net Worth—Debt	1.87–1	1.17–1	1.00–1	1.29–1	1.22–1
Net Worth—Fixed Assets	2.08–1	1.91–1	1.86–1	2.30–1	2.49–1
Merchandise—Receivables	.42–1	.48–1	.48–1	.47–1	.48–1
Sales—Merchandise	....	7.01–1	7.01–1	6.99–1	7.42–1
Collection Period	....	113 days	97 days	110 days	102 days
Sales—Fixed Assets	....	4.68–1	5.07–1	5.93–1	7.24–1
Sales—Net Worth	....	2.44–1	2.71–1	2.57–1	2.90–1
Profit on Sales	....	3.55%	0.52%	1.38%	2.11%
Profit on Net Worth	....	8.69%	1.42%	3.56%	6.12%
Acid Test	1.67–1	1.14–1	1.20–1	1.43–1	1.57–1

* Not audited.

unchanged. However, in January, 1924, a new credit manager came to the bank, and, after analyzing the December 31, 1923, statement of the Del Mar Printing Company, he spoke to Mr. Hartley about the account, suggesting that it might be desirable for the Elwood National Bank to discontinue its unsecured line and to discount acceptances for the company. The new credit manager stated that the company was more heavily in debt than an unsecured borrower should be, that the acceptances discounted had increased more rapidly during the preceding year than had

sales, and that the latter fact indicated a tendency on the part of the company to rely more and more on this type of borrowing. In view of this situation he felt that the Elwood National Bank's loan was not as well secured as were those of the Montgomery National Bank and the Presidio Trust Company. At Mr. Hartley's request the credit manager made inquiry of the two San Francisco banks known to be lending to the company, and found that they were satisfied with the manner in which the account was handled. The Presidio Trust Company included in the information furnished to the Elwood National Bank its record of the company's borrowings.[1]

Estimate the effect of the introduction of trade acceptances upon the amount of credit that a borrower can obtain, and that a bank can and should extend.

Should the contingent liability on acceptances discounted be shown in the company's balance sheet? What are the effects of this decision upon the credit ratios shown in this case?

Should the item, Plates, Dies, Etc., in this case, be treated in ratio analysis as goodwill, fixed assets, current assets, or none of these?

Did the Elwood National Bank appraise correctly the effects of the introduction of trade acceptances?

What action should the Elwood National Bank have taken in 1917, 1919, 1921, and in the spring of 1924?

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[1] Borrowings—Trade Acceptances Discounted

Year	Maximum Discounts	Average Discounts	Average Balance	Number of Months Out of Debt
1920	$31,200	$22,700	$2,500	0
1921	30,000	23,000	3,100	0
1922	29,300	23,800	3,800	0
1923	37,900	24,900	4,000	0

7. COMMODITY-SECURED LOANS

OXFORD NATIONAL BANK

COMMODITY-SECURED LOANS DURING 1920 AND 1921[1]

The Oxford National Bank, one of the largest banks in a New England city, made a part of its loans on the security of commodities pledged as collateral. A list of commodities thus pledged included cotton, cotton waste, yarn, print cloth, wool, hides, leather, grain, sugar, coffee, butter, eggs, and canned salmon. Loans on cotton and dairy products constituted a large portion of the total amount of commodity loans, and the bank endeavored to restrict these loans to staple products which were "readily marketable."[2] The officer and his assistants in charge of the loans devoted a large part of their time to the study of the various commodity markets. Leading trade journals were read, the forecasts of various economic services analyzed, and brokers and dealers questioned. This study furnished the knowledge necessary for the intelligent making of the loans and for the protection of the bank when future movements of commodity prices were uncertain.

The peculiarities of the various commodity markets and the different trade customs made it impossible to handle all commodity

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[1] References for use in this and subsequent cases pertaining to commodity-secured loans:

Harr and Harris, *Banking Theory and Practice*, second edition, pp. 184–192; Trant, J. B., *Bank Administration*, pp. 196–198; Willis and Steiner, *Federal Reserve Banking Practice*, pp. 230–234; Lincoln, E. E., *Applied Business Finance*, fourth edition, pp. 490–498, 502–505.

For a summary of the various legal devices safeguarding credit, see Appendix IV.

For a case concerning loans secured by cattle, see Farmers' Exchange Bank, *Harvard Business Reports*, Vol. 1, pp. 522–525.

Loans upon automobiles are treated in a separate section.

[2] "A readily marketable staple within the meaning of these regulations may be defined as an article of commerce, agriculture, or industry of such uses as to make it the subject of constant dealings in ready markets with such frequent quotations of price as to make (a) the price easily and definitely ascertainable, and (b) the staple itself easy to realize upon by sale at any time." (Regulation A of the Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, October, 1937, p. 984, footnote 3.)

loans in the same way.[1] As business conditions changed, more-over, the policy of the bank toward accepting certain commodities as collateral was altered. At one time the bank might advance money freely on coffee or hides, whereas at another time it might either demand a high margin for protection or refuse to loan at all. During the years of price inflation and deflation following the end of the World War, many of the problems of loaning on commodities were accentuated, and the following examples are taken from the Oxford National Bank's records of that period.

1. *M. B. Barnhart & Company.*—In February, 1920, Mr. M. B. Barnhart, senior partner of the firm of cotton brokers bearing his name, applied for a six months' loan of $50,000 for the purchase of low-grade Texas cotton. He submitted the following statement, accompanied by bank and trade references:

Assets		Liabilities	
Cash	$ 7,924	Liability to Bankers a/c Acceptances	$375,068
Accounts Receivable	45,759	Net Worth	195,795
Cotton	439,064		
Investment in Other Companies	75,612		
Sundry Assets	2,504		
	$570,863		$570,863

Mr. Barnhart had never been a customer of the Oxford National Bank, but he was well known in the city, and the loan officer believed that this loan, if granted, would lead to the opening of a valuable account. Reports from other bankers and from the trade, both in regard to the financial condition of the firm and the business ability and integrity of its members, were favorable. Mr. Barnhart agreed to endorse over to the bank warehouse receipts for 330 bales of Texas cotton of the grade

[1] In addition to these differences, there are certain peculiarities which distinguish commodity loans in general from those which are made on stocks and bonds as collateral. With commodities there is the risk of physical change as well as that of price. Furthermore, the bank does not ordinarily have physical possession of the commodities, but only of certain documents such as bills of lading, warehouse receipts, and trust receipts. The use of these documents complicates the technique of handling such loans.

specified, and to keep the cotton adequately insured and hedged.[1]

At that time this grade of cotton was selling at 38 cents per pound, having advanced 7 cents in the last 6 months.[2] Trade indications were that the demand would continue strong. A leading textile journal predicted, "Cotton prices are not going to be much lower except under an acute depression of business, and there is no indication of this at the present time. The outlook is for a much larger demand." An agent of the Department of Agriculture of the State of Texas urged farmers to hold their cotton for 45 cents per pound. A reputable commercial journal, although it sounded a warning of the dangers incident to inflation, recognized the probability of an increase in cotton prices in the immediate future. A statistical service forecasted that, although the next broad movement in the commodity would be downward, the decline might not make headway for several months, and that the peak might not have been reached. In its *Advance Letter on General Business Conditions*, dated February 7, 1920, the Harvard University Committee on Economic Research stated, "The continued decline of curve A indicates a recession in commodity prices and business activity beginning between April and December."

2. *H. D. Cornish & Company.*—The Oxford National Bank had an understanding with H. D. Cornish & Company, a firm of cotton brokers, that the bank would discount unsecured notes up to $100,000, provided a satisfactory balance was maintained, but that if the firm wished to borrow in excess of this amount, the entire indebtedness was to be placed on a secured basis.

In early November, 1920, the firm was borrowing $50,000. At that time Mr. Cornish informed the bank's loan officer that sales had been made to three mills, and that each sale was made with an agreement that the mill would take the cotton and pay for it at the contract price whenever the cotton was needed for manufacture. All the cotton, however, was to be taken up and paid for within six months. The three sales involved $400,000, divided as follows:

[1] The customary margin requirement was 20%, but this was not fixed. If, for example, cotton were selling at 14 cents per pound, a 10% margin would be considered adequate, but if prices rose to what seemed to be unwarranted levels, a margin higher than 20% would be required.

[2] For cotton prices in 1914, and 1917 to 1921, inclusive, see Exhibit 1 in case of Murphy Warehousing Corporation, *infra.*

Atlas Manufacturing Company	1,000 bales at 20 cents a lb.	$100,000
Borton Mills....................	2,000 bales at 20 cents a lb.	200,000
Federal Mills...................	1,000 bales at 20 cents a lb.	100,000
		$400,000

Mr. Cornish agreed to pledge enough free cotton to cover the existing loan of $50,000 by a margin of 20%, and asked the bank to advance $400,000 against the cotton sold to the mills.[1] The loan officer knew all the mills and felt confident that the Atlas Manufacturing Company and the Borton Mills would take up and pay for their cotton even though the price of cotton should fall during the next six months. Both mills were financially able to take a loss. With the Federal Mills the situation was different. The loan officer had never approved of the management, and, although the company was financially sound, he was not certain that the company would keep its contract with Cornish & Company if the price of cotton dropped sharply.

3. *Knight & Peters.*—This firm dealt in all varieties of cotton waste.[2] Both Mr. Knight and Mr. Peters were shrewd merchants, and the firm came through the falling market in the latter part of 1920 with unusually small losses. The inventory in May, 1921, was small, and the capital was adequate for the volume of business. At that time Mr. Peters asked for a loan of $35,000 for the purpose of buying cotton waste. He stated that he considered the current price of five cents a pound very low, and that his firm desired to purchase a considerable amount of waste with the intention of selling it at a profit on the first substantial rise in the market. The waste would be warehoused and pledged.

4. *Carton & Pringle.*—In April, 1921, Mr. Carton stated that he wished to buy 100 bales of wool from one of the large dealers at

[1] When banks loan on the security of sold cotton, the standing of the mill, as well as of the broker, and the value of the collateral must be considered. The mill gives the broker an accepted sales contract or sale note, and the broker pledges this together with the bill of lading when the cotton is in transit, or the warehouse receipt when the cotton is in storage. Cotton may be stored either in the warehouse of the mill or in an independent warehouse. As the cotton is drawn out, the mill makes payments, the bank receives the money, and the loan is correspondingly reduced. Because cotton loans are repaid in this installment fashion, banks prefer to make them demand rather than time loans In the case of loans on sold cotton, it is customary to loan 100% of the value of the cotton.

[2] Cotton waste, which is used as a substitute for cotton in certain of its uses, is separated from cotton during the process of manufacture and is similar to some of the poorer varieties of short staple cotton. In February, 1920, when cotton was selling at 40 cents per pound, good grades of waste were selling at about 22 cents per pound. At that time there was a substantial demand for waste, and it was used as a security for loans in much the same way as cotton.

26 cents per pound, making a total of about $13,000, for which the dealer would have to be paid within 10 days. He could sell this wool to a mill and make a profit of $800, but he would have to extend the mill 30-day terms. At this time Carton & Pringle's cash resources were $1,200, and Mr. Carton asked the bank to advance $12,000.

Carton & Pringle was a new firm of wool dealers. Both men were young, and they had started business with comparatively little capital. They sold wool on commission, but expected to become dealers for their own account as soon as they had accumulated sufficient capital. Since its formation in January, 1921, the firm had been a customer of the bank, and the bank officers were favorably impressed with the partners. The balance in the account averaged about $1,000. Because he believed in the future of the firm, the loan officer wished to enable it to buy the wool. It was customary to loan 80% of the value of pledged wool, but this form of loan could not be used in this case.[1] The officer suggested, therefore, that he would advance $12,000 upon Carton & Pringle's note, accompanied by an assignment to the bank of the account of the mill, covering this sale of wool. The loan officer knew the mill and felt certain that it would take care of this obligation. Wool prices are presented in Exhibit 1, Table 1.

5. *Flint Brothers Company.*—This concern was a wholesale grocery house which for many years had done a conservative business on a small, but stable, margin of profit. It had been a customer of the bank for some time and, on October 1, 1920, was using half of its $50,000 line. On that date Mr. Flint requested the loan officer to advance the other $25,000 on the credit line, and also asked him to loan $45,000 more, the additional sum to be secured by warehouse receipts for sugar. Ordinarily, Flint Brothers purchased about $25,000 worth of sugar a year, but this year Mr. Flint proposed to purchase $70,000 worth because he considered sugar at 12 cents per pound to be exceptionally low. He was "sure" that prices would soon turn up and that he would

[1] Loans on wool are not looked upon with favor by many banks, and the strongest wool dealers borrow on their own unsecured notes. When wool is pledged as collateral a 25% margin is usually required, and banks frequently ask borrowers to give nonnegotiable warehouse receipts in the bank's name in order to make possible partial releases without giving up the warehouse receipts. Independent warehouses are used. When the wool has been sold, the customer is often asked to assign the wool to the bank on a bailee receipt, together with the mill invoice. In some cases the mill is notified and payment is made directly to the bank.

be able to sell the sugar at a much higher price. Sugar prices are given in Exhibit 1, Table 2.

The then latest statement of Flint Brothers Company is shown in Exhibit 2.

EXHIBIT 1

Prices of Selected Commodities, 1914, 1919, 1920, and 1921*

Table 1
Wool
(Quarter blood combing, Ohio and Pennsylvania fleeces, grease basis, Boston, in cents per pound)

Month	1914	1919	1920	1921
January	22	68	66	27
February	23	63	68	27
March	24	63	66	27
April	24	55	64	28
May	26	56	62	28
June	26	60	54	26
July	27	67	47	24
August	27	68	44	23
September	27	68	42	24
October	27	66	38	24
November	28	66	32	26
December	29	66	29	29

Table 2
Granulated Sugar
(Unit: average of one price weekly, in cents per pound; including import duty, in barrels, f.o.b. New York)

Month	1914	1919	1920	1921
January	3.92	8.80	15.37	7.57
February	3.92	8.80	14.95	7.09
March	3.82	8.80	13.72	7.84
April	3.72	8.80	19.19	7.25
May	3.97	8.80	22.47	6.32
June	4.17	8.80	21.20	5.69
July	4.20	8.80	19.10	5.46
August	6.49	8.80	16.70	5.83
September	6.80	8.80	14.26	5.59
October	5.93	8.80	10.78	5.19
November	4.93	8.80	9.62	5.17
December	4.83	10.85	8.09	5.00

* Sources: Sugar, hides—Standard Statistics Company, *Statistical Bulletin;* Wool—United States Department of Commerce, *Record Book of Business Statistics* (Part 1).

EXHIBIT 1. (*Continued*)

Table 3
Hides
(Unit: average of one price weekly, in cents per pound; green salted packers' heavy native steers at Chicago)*

Month	1914	1919	1920	1921
January	18.00	28.00	40.00	16.75
February	18.25	28.00	40.25	13.63
March	18.13	27.60	36.40	11.50
April	18.00	29.50	36.13	10.13
May	18.25	35.10	35.38	11.88
June	18.50	40.80	34.10	13.95
July	19.38	48.60	29.44	13.88
August	20.50	52.00	28.50	14.05
September	21.00	46.40	28.40	14.06
October	21.25	48.20	25.50	14.81
November	21.75	46.90	23.25	15.80
December	22.50	41.00	19.00	16.50

* The price figures for Argentine "Frigorifico" hides show similar movements.

EXHIBIT 2

Financial Statement of Flint Brothers Company, as of June 30, 1920

Assets		Liabilities	
Cash on Hand and in Bank	$ 10,202	Accounts Payable	$ 45,310
Accounts Receivable	90,993	Notes Payable	34,318
Notes Receivable	29,134	Other Liabilities	21,727
Net Merchandise	58,581	Balance	150,655
Equipment	2,500		
Real Estate	55,260		
Other Assets	5,340		
	$252,010		$252,010

Operating Statement, for the Fiscal Year
Ending June 30, 1920

Gross Sales	$665,524
Cost of Goods Sold	598,706
Gross Profits	$ 66,818
Operating Expenses	53,421
Net Profit	$ 13,397

6. *The Montana Tanning Company.*—This company was a manufacturer of sole leather. On April 1, 1921, the balance sheet showed current assets of $750,000, of which 80% was hides,

stock in the process of manufacture, and finished leather. The company owed $150,000 to the Oxford National Bank and $100,000 to another bank in the same city. The company had trade indebtedness of $100,000. The plant was carried at $150,000 and mortgaged for $90,000. In addition, the Montana Tanning Company had endorsed $200,000 of notes for the Montana Leather Corporation, the sales subsidiary, but the latter company made a statement which indicated that it was good for its own indebtedness without recourse to the endorsement. The management of the tanning company was in competent hands.

The manager requested an additional loan of $250,000 for the purchase of hides in South America. He said that hides were cheap, that the demand for sole leather was picking up, and that he needed the hides for the increased business which he anticipated. The loan officer of the Oxford National Bank stated that he did not believe the bank would be justified in increasing the unsecured loans to the tanning company, but that the bank would finance the company's purchases of South American hides on an import letter of credit up to $250,000, provided that the bank could keep itself at all times secured by holding title to the hides.[1] This policy could be followed by releasing the hides under trust receipt when they arrived, with the agreement that the bank could at any time repossess itself of the hides or the proceeds thereof, whether they were in the raw, semimanufactured, or finished leather stage, or whether their proceeds were represented by accounts receivable, notes, or trade acceptances. The company would bind itself to apply the proceeds, whenever realized in cash, to the liquidation of this credit, and would further guarantee to keep these hides at all times segregated by proper distinguishing marks. Quotations for hides are presented in Exhibit 1, Table 3.

The M. B. Barnhart & Company loan:

(*a*) When is it necessary or desirable to take a specific pledge of collateral as security?

(*b*) How much might cotton be expected to fall in price?

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[1] The inventory burden is greater in tanning than in most other industries. There are several reasons for this: hides are subject to extreme fluctuation in price because they are a by-product of meat packing; the length of the manufacturing process for sole leather is four months; the hides must be contracted for in advance. The purchase of foreign hides necessitates contracting further in advance than the buying of domestic hides. A future market for trading in hides has been established, but the value of this market has not yet been proved.

(*c*) How far would cotton have to drop to absorb all of the borrower's capital?

(*d*) What action could the bank take if cotton prices fell?

(*e*) Should the cotton be hedged? If so, with whom?

(*f*) Should this loan be made?

(*g*) Would the decision be the same for an old customer?

The H. D. Cornish & Company loan:

(*a*) What security, pledged and unpledged, supports this loan?

(*b*) Is it a commodity loan?

(*c*) Should the bank grant this loan? If so, should the bank seek to vary any of the terms as stated?

The Knight & Peters loan:

(*a*) Is this a loan upon "staples"?

(*b*) What margin should the bank require?

(*c*) What weight should be given to the "name" in deciding whether to make a commodity-secured loan?

The Carton & Pringle loan:

(*a*) Is this a safe loan?

(*b*) Should it be granted? If so, at what rate?

(*c*) Should balance requirements be the same for commodity-secured loans as for customers' unsecured loans?

The Flint Brothers Company loan:

(*a*) What is the object of the borrower in requesting this loan?

(*b*) To what extent should any particular business concern anticipate its needs to purchase raw materials when prices are considered to be particularly favorable?

(*c*) When, if ever, should a bank facilitate speculative operations of its customers through loans?

(*d*) Will the bank lose this customer if it does not make the loan?

(*e*) Will the bank making a loan be blamed by the customer if the speculation proves to be unprofitable?

(*f*) Should this bank loan be made? If so, with what margin?

The Montana Tanning Company loan:

(*a*) Should a bank plan to forecast particular commodity prices in order to determine the safety of a loan, or is the margin supposed to cover all possible price fluctuations?

(*b*) Should this loan be made?

AMERICAN CAN CO. v. ERIE PRESERVING CO. AMERICAN CAN CO. v. NEW YORK COUNTY NATIONAL BANK AMERICAN CAN CO. v. TIMERMAN

183 Fed. Rep. 96 (U. S. C. C. A. 1910)

PLEDGE OF COMMODITIES—DELIVERY AND POSSESSION[1]

WARD, Circuit Judge. The Erie Preserving Company was engaged in the business of canning vegetables and fruit in factories at Irving, North Collins, and Model City, N. Y. The American Warehousing Company was engaged in what is known as "field storage warehousing"; that is, warehousing the owner's goods on the premises of the owner or of the former owner. This system is frequently practiced and is entirely effective when properly carried on. Phila. Co. v. Winchester (C. C.) 156 Fed. 600.

In August, 1907, the preserving company entered into an agreement with the warehousing company for the purpose of obtaining warehouse receipts for goods stored on its own premises; the receipts to be used as collateral for loans. To that end it leased all its premises to the warehousing company, and the warehousing company appointed one Wode, who was the preserving company's superintendent, to act as its own custodian of the warehoused goods. Various other agreements not necessary to mention were entered into to carry out the arrangement.

The course of dealing was that, upon requisitions of Wode, the warehousing company issued warehouse receipts for property actually on the premises to the order of the preserving company, which it endorsed and used as collateral. Receipts of this kind were held by the New York County National Bank, dated in June, 1908, and Arbuthnot, Latham & Co., dated from September, 1907, to March, 1908.

Other receipts similar in form were issued by Edward J. Sheridan, an employee of the preserving company, as a warehouseman, and used in the same way. Such receipts were held by Ladenburg, Thalmann & Co., dated in March, 1908, and by Conrad Heinrich Donner, dated in February, 1908, both of whom supposed that Sheridan was an independent warehouseman.

Other similar receipts were issued by Wode as a warehouseman and used in the same way. Such receipts were held by the Bank

[1] See case of McDonnell v. Bank of China, Ebersole, J. F., *op. cit.*, first edition, pp. 128–130.

of North Collins, dated January, February, and March, 1908. It knew that Wode was the superintendent of the preserving company, but appointed him as its own custodian of the goods mentioned in the receipt.

March 7, 1908, receivers of the preserving company were appointed in this suit by a stockholder and a general creditor, alleging that it was not able to meet its obligations in due course and praying that it be wound up and its assets distributed among its creditors. The defendant company in its answer admitted the allegations of the bill.

The goods mentioned in the receipts of the Bank of North Collins and goods in kind and amount of those mentioned in the other receipts were sold without prejudice to the rights of any one, and the holders of the receipts claim the proceeds or an equitable lien on the same.

Only one lease is in evidence, viz., that to the warehousing company for all the preserving company's premises. Sheridan testified that he had a "little lease" which was called for but not produced. Of course there could not be two leases of the same premises to different persons at the same time, and at the date of Sheridan's receipts the premises were leased to the warehousing company, which had a custodian there. Wode did not pretend to have any lease.

The business of the preserving company after the lease of its premises to the warehousing company went on in exactly the same way as before. Goods covered by the receipts, except in the case of the Bank of North Collins, were sold and other goods substituted. The use and occupation of all the premises by the preserving company were open, continuous, and exclusive. Care was taken by the warehousing company and by Sheridan that there should always be more goods of the same kind on the premises than were called for by the warehouse receipts, but none of the goods called for by the receipts were segregated or marked so as to be distinguished from the general stock of the preserving company, except in the case of the Bank of North Collins.

All the loans were made in entire good faith on the strength of the receipts and of the goods called for by them, and the preserving company intended to give a valid lien thereon. The receipts were assigned to the lenders for the purpose of pledging the goods, and we think the case turns on the question: Had the lenders valid pledges? A pledgee, though he may sell the pledge

if the debt is not paid, has only a lien upon and no title to it. The common law does not recognize a lien unaccompanied by possession either actual or constructive. This does not depend in any way upon fraud, actual or presumptive. We therefore need not examine the statutes or the law as to sales unaccompanied by delivery. We are not concerned with the questions whether such sales are void as absolutely fraudulent or only voidable as presumptively fraudulent, or whether all creditors may attack them or only creditors existing when the sales were made. The law as to pledges is clear, viz., that they are utterly invalid unless accompanied by actual or constructive possession. The subject is elaborately considered by Mr. Justice Bradley in Casey v. Cavaroc, 96 U. S. 467, 24 L. Ed. 779.

The judge of the Circuit Court rightly held that the receipts were invalid because the goods were not warehoused, and that there was no valid pledge because no delivery was made to the lenders except in the case of the Bank of North Collins.

Warehouse receipts would give constructive possession of goods actually warehoused; but it is plain that the warehousing company did not maintain a warehouse in any proper sense, because it had no exclusive and unequivocal possession. There is no pretense that either Sheridan or Wode were warehousemen at all. Yenni v. McNamee, 45 N. Y. 614. Therefore the holders of these receipts who had no actual possession had no constructive possession either. The Bank of North Collins has, however, been found both by the special master and the judge of the Circuit Court to have actually set apart and marked and kept in its own custody the goods described in its receipts which remained undisturbed down to the time receivers were appointed. We will adopt the conclusion of the court below as to its claim also because it did have actual possession and a valid lien.

It is contended by the holders of the receipts of the warehousing company and of Sheridan that they have an equitable lien. Equity would have compelled the preserving company to make actual delivery of the goods intended to be pledged, and it is said that the receivers standing in the place of the preserving company are subject to the same rule. But, though equity will treat that which ought to have been done as done between the parties, it will not do so to the prejudice of third parties. If the essential element of possession of property in existence was wanting to make the pledges good when receivers were appointed,

equity would not thereafter supply it to the detriment of general creditors.

All the orders are affirmed, with costs.

What essential point for bank lending officers is established by this decision?

What steps should have been taken, or restrictions imposed, by the banks before making these loans upon warehouse receipts?

BINARY BANK

SPECIAL PROBLEMS IN COMMODITY-SECURED LOANS

The Binary Bank, one of the largest banks in New York State, had no hard and fast rules relating to the granting of commodity loans but considered each such loan as a special case, which required separate analysis and decision.

1. *Crookes Cotton Company.*—A representative of the Crookes Cotton Company, a small firm of cotton brokers, came to the bank in December, 1927, to obtain a loan on the security of pledged cotton. This man stated that his company had recently received a shipment of 250 bales of long-staple Egyptian cotton, which it had placed in the hands of a well-known warehousing company in Brooklyn and upon which it wished to borrow. The Crookes Cotton Company had never done any business with the Binary Bank but promised that if it obtained a loan of 80% of the value of its stored cotton it would open an account at the bank and maintain the customary balances. On investigating the standing of the Crookes Cotton Company, the bank found that it was a newly organized concern but was generally well regarded in the trade. The bank's loan department considered Egyptian cotton excellent collateral and held a favorable opinion of the warehouse in which this commodity had been stored. This transaction promised to bring in an account which might prove of considerable future value to the bank. Accordingly, the bank made the loan, following its usual custom of not checking the collateral but relying merely on the honesty of the customer and on the warehouse receipt, which later was proven to be forged by a change in the description of quality.

When the Crookes Cotton Company's 90-day note fell due, the Binary Bank was requested to renew it for a similar period. It was unusual for a new customer not to be prompt in paying off the first loan made to it, and the bank decided to sample the pledged cotton before making the requested renewal. When the bales indicated by the warehouse receipt numbers were opened by the bank's investigator, over half of them were found to contain cotton waste.

2. *Lars Larsen.*—During the fall of 1929 Lars Larsen, a Scandinavian hardware merchant, came to the loan department of the Binary Bank to discuss a possible loan. Mr. Larsen had maintained a personal account with the bank for some years, but the Larsen Hardware Company did its borrowing at a small uptown bank. Mr. Larsen explained that he expected the Hawley-Smoot Tariff to place a prohibitive duty on high-quality Swedish files. For that reason he was anxious to obtain a large supply before the measure became law, since he was sure he would make a fair profit on the transaction and would in all probability realize a margin of upwards of 100% if the duty which he looked for were included in the tariff as finally enacted. Mr. Larsen stated frankly that he wished to purchase more of these files than he had sold in his own store in the 20 years since the business was organized. He was certain that he would be able to pay off the loan in a year with the proceeds of sales of the files to other merchants, and that the bank would run no risk in lending him 85% of the invoice value of this merchandise upon trust receipts.[1] The bank knew Mr. Larsen to be an honest, thrifty, and shrewd merchant.

3. *Airflow Motor Corporation.*—The Airflow Motor Corporation had been engaged for many years in the manufacture of high-powered motor cars noted for their unusual body design rather than for their mechanical perfection. The company had produced its first car in 1900 and had built many trucks for war use in 1917–1918. By 1928, however, it was concentrating almost entirely on pleasure automobiles for sale to the very wealthy. At that time its plant covered 45 acres and had a floor area of approximately 1,500,000 square feet.

At the ouset of the depression, with the attendant financial reverses of the company's class of customers, its sales collapsed. In 1934, operations were temporarily suspended, and in August of that year the company entered bankruptcy under Section 77B. Early in 1935, a plan of reorganization was declared effective, under which the stockholders received only the right to purchase new preferred stock.

In March, 1937, after two more years of unprofitable operations, during which the company borrowed $1,000,000 from a local

[1] For the legal phase, consult Frederick, K. T., "The Trust Receipt as Security," *Columbia Law Review*, Vol. XXII, pp. 395–420, 546–562 (May and June, 1922), reprinted in pamphlet form by the American Acceptance Council.

bank on a note secured by a first mortgage on its plant and equipment, the company was considering a reorganization and refinancing program. The plant was shut down except for the production of service parts and special-order motors. Arrangements for the underwriting of a proposed issue of $11,000,000 of preferred stock were made with a reputable investment banking firm. It was estimated that about six months' time and about $200,000 would be required to provide for the registration and sale of the issue.

Since the company did not have $200,000 available, it opened negotiations with the Binary Bank. The bank would not lend on the company's unsecured note but indicated a willingness to advance the funds on a short-term note secured by warehouse receipts covering various body and motor parts and raw materials on hand, such as steel, aluminum, and veneers. A large field warehousing[1] company was hired to establish on the company's premises a warehouse consisting of 35 rooms or buildings. Appropriate steps were taken to insure the fulfillment of a complete bailment.

4. *Grand Strike Gold Mining Company.*—The Grand Strike Gold Mining Company could not transport its gold to market from November 1 to May 1 each year because of heavy snowfalls in its vicinity. Since it did not have sufficient reserves of working capital to continue production without sale during that period, the company had been unable to operate continuously throughout the year. Each year it had built up a small inventory of gold concentrates, but every year prior to 1935 a cessation of operations had been necessitated long before the spring thaw.

The company's property consisted of a single mine located in California and a simple table concentrating mill capable of producing approximately one ton of concentrates per day. The company customarily sold a high proportion of its output to the Cliff Company, a large smelting and refining company. The company had invested heavily in machinery and other fixed assets in 1935. The average value of the concentrates was $450 per ton. Payrolls and operating expenses combined were never below $2,000 or more than $3,000 per month.

The management had intended to close the mine as usual on December 1, 1935, because of insufficient funds. Exhibit 1 pre-

[1] For a more complete case upon field warehousing, see Berry Preserve Company, *infra.*

sents the balance sheet as of that date. Early in November, however, the Cliff Company approached the representative of a large field warehousing company to determine whether or not the mining company could obtain a bank credit secured by warehouse receipts issued against gold concentrates produced during the winter months. The field warehousing company declared that it could set up a warehouse at the mine, and that the Binary Bank had agreed to grant a line of $20,000.

EXHIBIT 1

Balance Sheet of the Grand Strike Gold Mining Company, as of December 1, 1935

(Approximate figures)

Assets		Liabilities	
Cash	$ 6,500	Accounts Payable	$ 5,500
Inventory (Estimated Net)	5,000	Accrued Wages	1,500
Plant and Equipment	90,000	Notes Payable*	77,000
Supplies	20,000	Capital Stock†	100,000
Real Estate	300,000	Paid-in Surplus	200,000
		Earned Surplus	37,500
	$421,500		$421,500

* Notes payable to officers of the company.
† 1,000,000 shares.

A bonded warehouse manager and a bonded watchman were installed at the mine, and all the necessary precautions were taken to insure that these men took legal possession of the gold concentrates as they came out of the mill. Periodically, reports and samples covering the production were sent by snowshoe messenger to the post office of the nearest town. On the basis of these reports, warehouse receipts were issued and taken to the bank, which made advances thereupon.

Under this arrangement, the mining company operated continuously throughout the winter months and borrowed to the full extent of its credit line. In the spring the concentrates were released from the warehouse and shipped by truck to the smelting company in the name of the bank holding the receipts. After the smelting process and the sale of the gold, the bank and the warehouse company were paid in full.

The Crookes Cotton Company loan:

(*a*) Should a bank verify every warehouse receipt offered as collateral before advancing funds? (*b*) What steps should

the bank take in this case in an endeavor to recover the funds advanced?

The Lars Larsen loan:

(*a*) Appraise the prospective borrower and the value of the account. (*b*) Indicate the factors which might affect the value of the commodity purchased. (*c*) Analyze the nature of the proposed business transaction and be prepared to state whether or not it is of the type which a bank should finance. (*d*) What would be the term of this loan? (*e*) Are trust receipts necessary?

The Airflow Motor Corporation loan:

(*a*) Estimate the relation between the present value and the possible future value of the collateral offered. (*b*) Enumerate and appraise the potential sources of funds for repayment.

The Grand Strike Gold Mining Company loan:

(*a*) What are the merits and demerits of gold concentrates as commodity security? (*b*) Why was any pledge necessary?

GRANGER FLOUR MILLS COMPANY

COMMODITY-SECURED LOAN TO A WHEAT MILLER

The Granger Flour Mills Company, which was located in a small middle western city, produced high-quality wheat flour. In October, 1924, Mr. George Thomas, the president of the concern, called on the Mid-Continent National Bank of Chicago to make inquiry regarding bank loans secured by stored wheat. Mr. Thomas informed the Mid-Continent National Bank that he was dissatisfied with the manner in which his company's secured loans were being handled by the local bank then having this business. He outlined the restrictions imposed upon such loans, as follows: (1) a margin of 20% at market value of the wheat at all times; (2) storage in a public elevator; (3) hedging of all purchases; (4) full insurance of wheat at all times; (5) release of wheat from storage only against cash payment; and (6) the customary 20% balance requirement while the Granger Flour Mills Company was in the bank's debt.

Mr. Thomas stated that he believed a bank would be justified in imposing these conditions on a dealer whose activities were restricted to buying and selling actual grain, and who could offer no security except this grain for his promise to pay. He felt, however, that an established business such as that of the Granger Flour Mills Company should be allowed more latitude in furnishing security for its loans. He summarized seriatim his objections to the aforesaid restrictions placed on the loans secured from his company's present banking connection, as follows:

1. As to margin, the Granger Flour Mills Company was not dependent on the wheat market for its profits. The grain purchased was used solely to manufacture flour, thereby adding to the value of the product. During the 14 years in which the company had operated, milling had yielded an average annual net profit of 3% on sales, regardless of price fluctuations on the grain exchange.

2. As to storage in a public elevator, this requirement resulted in considerable inconvenience and expense. Mr. Thomas felt

it to be an undesirable reflection upon the honesty of the management of the Granger Flour Mills Company.

3. As to hedging, he stated that insurance of this kind was not necessary for all the transactions of a milling company, and that the Granger Flour Mills Company often did hedge its purchases of unpledged wheat. A large part of the company's business was done on a contract basis, contracts being drawn up at a price which would yield the Granger Flour Mills Company a fair profit on wheat purchased at current levels. On this class of transactions Mr. Thomas felt that hedging was unnecessary.

4. As to releasing wheat from storage only against cash payment, Mr. Thomas objected most violently. He felt that it was unjust to the Granger Flour Mills Company and that it worked against the desire of the bank to have the most valuable security possible for its loans. He admitted that it was impossible to identify the wheat which had been pledged to the bank after it was started in the milling process and after it had been converted into flour. He stated that the Granger Flour Mills Company might as well not borrow against wheat at all if it had to pay off these loans long before it could realize upon the finished products. He pointed out that if a bank would release wheat against trust receipts giving it a claim to a proportionate amount of flour, to be set aside for it by the borrowing company, the security for the loan would be increased by the value which was added by manufacture to each bushel of grain. To take a concrete example, wheat was selling in October, 1924, at $1.52 per bushel, and flour at $8.01 per barrel, as shown in Exhibit 1. It required four and one-half bushels of wheat to produce one barrel of flour. If, then, a bank loaned $5 against four and one-half bushels of wheat, its margin would be $1.84, or 36.8% of the loan. When this wheat became flour, however, the margin would be increased to $3.01, or 60.2% of the loan.

Mr. Thomas then described what he considered to be a more satisfactory basis for borrowing against wheat, and inquired whether the Mid-Continent National Bank would care to lend under such an arrangement. The Granger Flour Mills Company would borrow on 90-day renewable notes, each note to be for $25,000 and secured by 20,000 bushels of standard-grade, high-quality wheat. On this basis the bank's loans would be covered if the market price of the grain purchased by the Granger Flour

Mills Company averaged $1.25 per bushel. Mr. Thomas believed this to be a fair figure. When the Granger Flour Mills Company wished to take the wheat into its mill, the bank would permit the substitution of one barrel of flour for each four and one-half bushels of grain released. Mr. Thomas pointed out that even at $6.04 per barrel, the lowest price reached in recent years, the bank would have ample coverage, since at that minimum figure the 4,444 barrels of flour substituted for each $25,000 note would be worth $26,842. The Granger Flour Mills Company would agree to keep the bank's collateral fully insured at all times, would maintain balances commensurate with its borrowings, and, Mr. Thomas intimated, would not quibble over reasonable rates of interest.

EXHIBIT 1

Prices of Wheat and Flour, by Months, 1923 and 1924*

Month	Wheat Prices (Unit: average of one price weekly in dollars per bushel; No. 2 red winter, cash, at Chicago)		Flour Prices (Unit: average of one price weekly in dollars per 196 pound barrel; wheat, standard patents, f.o.b. Minneapolis)	
	1923	1924	1923	1924
January	1.25	1.13	6.63	6.16
February	1.35	1.13	6.70	6.28
March	1.31	1.09	6.63	6.30
April	1.31	1.07	6.96	6.35
May	1.29	1.06	6.60	6.64
June	1.19	1.12	6.26	6.88
July	.99	1.26	6.04	7.63
August	1.02	1.32	6.06	7.54
September	1.05	1.34	6.25	7.44
October	1.10	1.52	6.20	8.01
November	1.06	1.56	6.04	8.16
December	1.08	1.77	6.10	8.90

* Source: Standard Statistics Company, *Statistical Bulletin.*

The Mid-Continent National Bank found, on investigation, that the product of the Granger Flour Mills Company had an excellent reputation in the trade, that the company met its bills promptly, and that the management was well regarded both as to ability and honesty. The bank felt also that the company's

financial statement, as shown in Exhibit 2, made a good showing. Accordingly, it agreed to lend any reasonable amount on the basis suggested by Mr. Thomas.

EXHIBIT 2

Financial Statement of Granger Flour Mills Company, as of December 31, 1923

	1923
Assets	
Cash	$ 72,313
Notes Receivable	5,447
Accounts Receivable	108,147
Inventory: Finished	104,147
Unfinished	382,413
Current Assets	$ 672,467
Land and Building	200,000
Machinery and Equipment	307,162
Investments	70,000
Total Assets	$1,249,629
Liabilities	
Notes Payable—Banks	$ 225,000
Accounts Payable	1,747
Current Liabilities	$ 226,747
Reserves	92,750
Common Stock	100,000
Surplus	830,132
Total Liabilities	$1,249,629
Sales	$3,332,155
Profits	Not reported
Current Ratio	2.96–1
Net Worth—Debt	4.10–1
Net Worth—Fixed Assets	1.83–1
Merchandise—Receivables	4.28–1
Collection Period	12 days
Sales—Merchandise	6.84–1
Sales—Net Worth	3.58–1
Sales—Fixed Assets	6.57–1
Acid Test	.81–1

Between 1924 and 1930 the relations between the Granger Flour Mills Company and the Mid-Continent National Bank were entirely satisfactory to the latter. The company, which had never borrowed over $100,000 at one time, paid all its notes promptly at maturity, never questioned an increase in the rate of interest

charged on its borrowings, and kept balances which were more than adequate.[1]

In June, 1930, the bank became somewhat concerned about this loan. Wheat and flour prices had suffered drastic declines, as shown in Exhibit 3, and the bank had learned from trade quarters that the Granger Flour Mills Company was specializing more and more on a lower grade product. On the other hand, the concern's financial statements, reproduced in Exhibit 4, continued to show a sound condition.

EXHIBIT 3

Prices of Wheat and Flour, by Months, January, 1925, to May, 1930*

Month	Wheat Prices (Unit: average of one price weekly in dollars per bushel; No. 2 red winter, cash, at Chicago)						Flour Prices (Unit: average of one price weekly in dollars per 196-pound barrel; wheat, standard patents, f.o.b. Minneapolis)					
	1925	1926	1927	1928	1929	1930	1925	1926	1927	1928	1929	1930
January	1.98	1.87	1.37	1.41	1.37	1.25	9.69	9.41	7.46	7.45	6.34	6.75
February	2.01	1.84	1.37	1.50	1.41	1.18	9.85	9.14	7.42	7.48	6.81	6.39
March	1.85	1.71	1.34	1.61	1.35	1.11	9.03	8.80	7.33	7.54	6.64	6.20
April	1.73	1.70	1.35	1.80	1.28	1.11	8.33	8.75	7.25	8.11	6.50	6.07
May	1.90	1.62	1.44	1.86	1.20	1.08	8.87	8.49	7.83	8.49	6.18	5.97
June	1.84	1.48	1.45	1.75	1.24	....	8.53	8.65	7.91	7.95	6.38	....
July	1.58	1.43	1.44	1.38	1.40	....	8.65	8.79	7.81	7.46	7.69	....
August	1.67	1.37	1.39	1.32	1.30	....	8.84	7.95	7.62	6.69	7.34	....
September	1.68	1.35	1.31	1.50	1.32	....	8.31	7.73	7.06	6.59	7.17	....
October	1.60	1.41	1.35	1.44	1.30	....	8.26	7.94	7.19	6.40	6.91	....
November	1.70	1.38	1.34	1.26	1.23	....	8.54	7.74	7.13	6.27	6.69	....
December	1.81	1.41	1.34	1.38	1.35	....	9.25	7.63	7.10	6.14	6.88	....

* Source: Standard Statistics Company, *Statistical Bulletin*, and *June Supplement, 1930*.

1

Year	Average Loan	Average Ledger Balance	Number of Months Out of Debt
1924	$47,000	$14,800	1
1925	56,000	9,300	2
1926	50,000	16,600	0
1927	54,000	18,200	1
1928	50,000	18,300	1
1929	68,000	21,800	0

EXHIBIT 4

Financial Statements of Granger Flour Mills Company, as of December 31, 1924 to 1929*

	1924	1925	1926	1927	1928	1929
Assets						
Cash	$ 88,220	$ 111,129	$ 89,375	$ 147,011	$ 115,364	$ 82,024
Notes Receivable	....	....	14,885	2,341	....	....
Accounts Receivable	119,314	127,603	112,943	107,255	113,966	110,027
Inventory: Finished	88,648	179,270	131,279	105,759	178,366	192,358
Unfinished	425,066	315,198	369,230	353,320	324,585	502,324
Current Assets	$ 721,248	$ 733,200	$ 717,712	$ 715,686	$ 732,281	$ 886,733
Land and Buildings	200,000	200,000	270,000	348,471	397,794	270,000
Machinery and Equipment	307,163	307,163	332,967	333,912	333,912	418,757
Investments	70,000	70,000	7,892	30,613	26,061	44,415
Total Assets	$1,298,411	$1,310,363	$1,328,571	$1,428,682	$1,490,048	$1,619,905
Liabilities						
Notes Payable—Banks	$ 225,000	$ 225,000	$ 225,000	$ 250,000	$ 250,000	$ 360,000
Accounts Payable	529	512	755	1,244	746	2,560
Current Liabilities	$ 225,529	$ 225,512	$ 225,755	$ 251,244	$ 250,746	$ 362,560
Common Stock	100,000	100,000	100,000	100,000	100,000	100,000
Surplus	972,882	984,851	1,002,816	1,077,438	1,139,302	1,157,345
Total Liabilities	$1,298,411	$1,310,363	$1,328,571	$1,428,682	$1,490,048	$1,619,905
Sales	$4,122,462	$4,233,934	$4,362,219	$4,287,164	$3,833,081	$3,516,737
Current Ratio	3.19–1	3.25–1	3.17–1	2.84–1	2.92–1	2.44–1
Net Worth—Debt	4.75–1	4.81–1	4.88–1	4.68–1	4.94–1	3.46–1
Net Worth—Fixed Assets	2.11–1	2.13–1	1.82–1	1.72–1	1.69–1	1.82–1
Merchandise—Receivables	4.30–1	3.87–1	3.91–1	4.18–1	4.41–1	6.31–1
Collection Period	10 days	11 days	10 days	9 days	10 days	11 days
Sales—Merchandise	8.02–1	8.56–1	8.71–1	9.33–1	7.62–1	5.06–1
Sales—Net Worth	3.84–1	3.90–1	3.95–1	3.64–1	3.09–1	2.79–1
Sales—Fixed Assets	8.12–1	8.34–1	7.23–1	6.28–1	5.23–1	5.10–1
Acid Test	.92–1	1.05–1	.96–1	1.02–1	.91–1	.52–1

* *Audited.*

MURPHY WAREHOUSING CORPORATION

COMMODITY-SECURED LOANS TO COTTON MANUFACTURERS

In June, 1919, Mr. R. N. Day, a representative of the Murphy Warehousing Corporation, called on the Home Trust Company in a New England textile center in regard to obtaining loans secured by cotton in storage. The Murphy Warehousing Corporation was the joint property of three cotton manufacturing concerns which operated mills in the vicinity. The function of the subsidiary company was to purchase raw cotton and store it until such time as it was to be placed in the process of manufacture.

Mr. Day explained that the companies which controlled the Murphy Warehousing Corporation were unanimously of the opinion that cotton prices, which had been rising steadily since early in the year (see Exhibit 1), were going to continue upward, and that it would be desirable to purchase more cotton than usual during the fall of 1919.

EXHIBIT 1

Cotton Prices*

(Unit: average of one price weekly in cents per pound at New York—spot middling uplands)

Month	1914	1917	1918	1919	1920	1921
January	12.72	17.59	32.26	29.10	39.26	16.63
February	12.83	15.90	31.75	26.27	38.77	13.44
March	13.27	18.46	33.74	27.68	41.20	11.74
April	13.23	20.38	31.85	28.82	42.30	12.14
May	13.44	20.74	27.57	30.58	41.25	12.84
June	13.46	25.33	30.39	32.96	39.27	12.00
July	13.17	26.30	31.54	35.33	41.20	12.41
August	11.00	25.49	33.88	32.10	36.23	13.79
September	†	23.05	35.09	30.60	30.07	19.95
October	†	28.02	32.42	34.98	22.68	19.63
November	7.67	29.78	29.69	39.40	18.81	18.01
December	7.53	30.74	30.22	39.19	15.68	18.30

* Source: Standard Statistics Company, *Statistical Bulletin*.
† Market closed.

Mr. Day approached the Home Trust Company at the request of Mr. Gresham, the president of Gresham & Calfee, one of the

joint owners of the warehousing company. Mr. Gresham was a director of the Home Trust Company and wished to offer the bank a participation in the Murphy Warehousing Corporation's business.

The basis upon which the Murphy Warehousing Corporation conducted its business was outlined by Mr. Day, as follows:

1. The warehousing company had an agreement with each of the manufacturing concerns, a copy of which was submitted to the Home Trust Company, as follows:

> The Murphy Warehousing Corporation, herein called the company, agrees to purchase cotton of such grades and staples and in such quantities as *Gresham & Calfee* may direct. The company agrees to receive said cotton as agent for *Gresham & Calfee*, and to store said cotton in its warehouse free of all expense other than insurance until the same shall be sold and delivered to *Gresham & Calfee* from time to time in quantities as desired at the full invoice price paid for said cotton by the company. The company further agrees to keep said cotton fully insured against loss by fire, the cost of such insurance to be remitted by *Gresham & Calfee* at the time of the purchase of said cotton from the company.
>
> Signed: MURPHY WAREHOUSING CORPORATION
>
> Signed: GRESHAM & CALFEE

2. Upon receipt and execution of an order to purchase cotton, the Murphy Warehousing Corporation sent the following form to the manufacturing company for which it made the purchase:

> To: *Gresham & Calfee*
>
> We have this day purchased on original sale note from ——— ——— *One Hundred* (*100*) bales of cotton marked *LOUF*, transferred said cotton to our warehouse, and will hold for your accommodation *100* bales of said cotton at *28.15* cents per pound.
>
> Grade *Middling "B"* Staple *1 in.*
>
> Signed: MURPHY WAREHOUSING CORPORATION

3. When the cotton was received by the Murphy Warehousing Corporation, nonnegotiable, single-bale warehouse receipts were issued against it and turned over to a lending bank, accompanied by a copy of the invoice and the following documents:

> For valuable consideration, we hereby transfer all right and title to the cotton described in the within invoice to the ——— Bank.
>
> Signed: MURPHY WAREHOUSING CORPORATION

In consideration of being allowed to store this cotton in the warehouse of the Murphy Warehousing Corporation, we hereby guarantee the payment of its invoice price to the————Bank. We also guarantee that said cotton will be kept fully insured and that in the event of loss the proceeds from insurance will first be applied to satisfy the————Bank.

Signed: GRESHAM & CALFEE

4. Release of cotton by the lending bank was never asked for except on payment by the Murphy Warehousing Corporation, which received the funds from a duly executed sale to the manufacturing company for which the cotton had been bought and stored. Deliveries to manufacturing companies were made in varying amounts, but the use of single-bale warehouse receipts made release easy.

Mr. Day told the Home Trust Company that the Murphy Warehousing Corporation had always borrowed up to the full invoice price of the stored cotton because this price was guaranteed to it by the particular manufacturing company directing its purchase. He stated also that the warehousing company did not keep any balances at the banks from which it borrowed. In regard to interest rates on loans, which were all made on a 90-day basis with the privilege of one renewal, he said that he believed 5½% to be a fair figure at the time, but that the company would expect reductions in this rate in the event of an easing in the money market. If the Home Trust Company wished to have a part of this business, which Mr. Day did not believe would exceed a loan of $250,000 at any one time, it would be expected to take it on the stated conditions.

The Murphy Warehousing Corporation, which had a nominal capitalization of $100, issued no financial statements. Its employees were on the payrolls of the controlling companies, and what little liquid capital it required to pay insurance and for other purposes was advanced by these companies in current account. Its fixed plant appeared as Investment in Subsidiary on the statements of Gresham & Calfee and their two associates.

At the request of the Home Trust Company, Mr. Day furnished it with copies of the balance sheets, shown in Exhibit 2, of Gresham & Calfee, the Martin Cotton Mills, and the Cory Textile Company, which were the three concerns interested in the Murphy Warehousing Corporation. He stated that none of the companies had ever published their operating figures.

EXHIBIT 2

Financial Statements of the Three Controlling Companies, as of December 31, 1917 and 1918*

	Gresham & Calfee		Martin Cotton Mills		Cory Textile Company	
	1917	1918	1917	1918	1917	1918
Assets						
Cash						
Marketable Securities	$ 411,616	$ 556,195	$ 469,369	$ 424,389	$ 257,828	$ 324,574
Accounts Receivable						
Advances to Subsidiary	3,425	2,113	2,203	3,007	1,721	1,993
Prepayments on Merchandise	39,473	43,204	46,054	40,581		
Inventory	425,397	500,147	737,470	780,653	493,318	690,078
Current Assets	$ 879,911	$1,101,659	$1,255,096	$1,248,630	$ 752,867	$1,016,645
Land and Buildings	834,741	2,638,777	383,504	383,504	1,706,852	1,714,267
Machinery and Equipment	1,624,248		688,578	650,855		
New Construction				310,710		
Investment in Subsidiary	50,600	51,750	50,600	51,750	50,600	51,750
Total Assets	$3,389,500	$3,792,186	$2,377,778	$2,645,449	$2,510,319	$2,782,662
Liabilities						
Accounts Payable	$ 71,519	$ 56,814	$ 18,079	$ 75,540	$ 34,362	$ 48,160
Notes Payable			250,000	100,000	150,000	
Accruals			24,997		4,642	2,342
Reserve for Taxes	27,843	27,460		10,873		
Current Liabilities	$ 99,362	$ 84,274	$ 293,076	$ 186,413	$ 189,004	$ 50,502
Funded Debt					278,500	140,500
Reserve for Depreciation	460,092	839,253	200,000	272,000	283,111	504,751
Capital Stock	2,000,000	2,000,000	1,350,000	1,350,000	1,100,000	1,100,000
Surplus	830,046	868,659	534,702	837,036	659,704	986,909
Total Liabilities	$3,389,500	$3,792,186	$2,377,778	$2,645,449	$2,510,319	$2,782,662
Current Ratio	8.85–1	13.07–1	4.28–1	6.69–1	3.98–1	20.13–1
Net Worth—Debt	28.48–1	34.03–1	6.43–1	11.73–1	3.76–1	10.92–1
Net Worth—Fixed Assets	1.41–1	1.59–1	2.16–1	2.03–1	1.23–1	1.72–1

* Audited.

All three of the manufacturing companies were reputable and well known in the textile trade. Gresham & Calfee produced medium-grade dress goods and the Cory Textile Company a higher quality of similar materials, while the Martin Cotton Mills specialized in sheetings. The Home Trust Company knew that there was a close connection between these concerns. Mr. Gresham, for example, was a director of both the Cory Textile Company and the Martin Cotton Mills. The bank thought well of Mr. Gresham and his associates.

In the latter part of July, 1919, the Home Trust Company made a loan of approximately $35,000 to the Murphy Warehousing Corporation on the conditions as laid down by Mr. Day. At the same time the bank expressed its willingness to make loans on this basis for any reasonable amount.

The loan arrangement with the Murphy Warehousing Corporation was reviewed in June, 1930, consideration being given to price data, as shown in Exhibit 3, and the financial statements of the three manufacturing companies, reproduced in Exhibit 4.

EXHIBIT 3

Cotton Prices*

(Unit: average of one price weekly in cents per pound at New York—spot middling uplands)

Month	1927	1928	1929	1930
January	13.42	19.12	20.23	17.22
February	14.11	18.36	20.22	15.62
March	14.33	19.37	21.19	15.18
April	14.77	20.62	20.33	16.42
May	16.04	21.73	19.63	16.43
June	16.85	21.54	18.72	.....
July	17.99	21.71	18.62	.....
August	20.04	18.28	18.64	.....
September	21.93	18.65	18.85	.....
October	20.96	19.62	18.46	.....
November	20.22	19.92	17.53	.....
December	19.81	20.46	17.27	.....

* Source: Standard Statistics Company, *Statistical Bulletin*, and *June Supplement, 1930*.

Was the Home Trust Company justified in its action?

Would the answer be different if the same proposal had been made to the bank in June, 1930?

EXHIBIT 4

Financial Statements of the Three Controlling Companies, as of December 31, 1928 and 1929*

	Gresham & Calfee		Martin Cotton Mills		Cory Textile Company	
	1928	1929	1928	1929	1928	1929
Assets						
Cash			$ 13,951	$ 35,405		
Marketable Securities	$ 239,534	$ 454,715	169,916	74,033	$ 344,069	$ 293,370
Accounts Receivable			75,426	139,093		
Advances to Subsidiary	1,303	1,562	1,473	772	972	814
Prepayments on Merchandise	74,260	67,240	36,074	35,599	....	....
Inventory	843,234	853,053	470,137	499,371	632,194	553,592
Current Assets	$1,158,331	$1,376,570	$ 766,977	$ 784,273	$ 977,235	$ 847,776
Land and Buildings	3,783,460	3,744,016	1,635,041	1,635,041	2,333,306	2,343,026
Machinery and Equipment						
Investment in Subsidiary	26,001	23,760	26,001	23,760	26,001	23,760
Total Assets	$4,967,792	$5,144,346	$2,428,019	$2,443,074	$3,336,542	$3,214,562
Liabilities						
Accounts Payable	$1,348,712	$1,125,102	$ 64,197	$ 73,373	$ 353,505	$ 337,171
Notes Payable			....	145,000		
Current Liabilities	$1,348,712	$1,125,102	$ 64,197	$ 218,373	$ 353,505	$ 337,171
Funded Debt	....	....	....	....	7,500	7,500
Preferred Stock	....	750,000	750,000	750,000	750,000	750,000
Common Stock	2,300,000	2,300,000	600,000	600,000	1,050,000	1,050,000
Reserve for Depreciation	1,369,612	1,260,929	652,947	664,476	1,175,537	1,069,891
Surplus	50,532(d)	291,685(d)	360,875	210,225		
Total Liabilities	$4,967,792	$5,144,346	$2,428,019	$2,443,074	$3,336,542	$3,214,562
Current Ratio	.85–1	1.22–1	11.94–1	3.59–1	2.76–1	2.51–1
Net Worth—Debt	1.66–1	2.45–1	26.65–1	7.14–1	....	....
Net Worth—Fixed Assets	.93–1	1.11–1	1.74–1	1.60–1	....	....
Merchandise—Receivables	....	....	6.71–1	3.84–1	....	....

* Audited.
(d) Deficit.

BAYOU BANK & TRUST COMPANY

COMMODITY-SECURED LOANS TO COTTON BROKERS

The Bayou Bank & Trust Company of New Orleans had among its secured borrowers two firms of local cotton brokers, Lewis & Cates, and the Delta Cotton Company. Each of these concerns met the usual margin requirement set by the Bayou Bank & Trust Company on pledged cotton, which was to limit borrowings to $10 less than the market price on every bale pledged. (See Exhibit 1.) Each company paid the same rate of interest, and each stored its cotton in the largest bonded warehouse in New Orleans.

EXHIBIT 1

Cotton Prices*
(Unit: average of one price weekly in cents per pound at New Orleans—spot middling)

Month	1926	1927	1928	1929	1930
January	20.14	13.15	18.57	19.10	16.85
February	19.93	13.74	18.07	19.15	15.32
March	18.40	14.10	19.03	19.91	14.84
April	18.09	14.30	19.78	19.18	.....
May	18.02	15.73	20.91	18.79	.....
June	17.62	16.41	20.96	18.88	.....
July	17.22	17.65	21.24	18.71	.....
August	18.13	19.67	18.89	18.65	.....
September	16.11	21.40	17.81	18.58	.....
October	12.70	20.84	18.75	18.14	.....
November	12.59	20.06	18.91	17.18	.....
December	12.24	19.20	19.42	17.07	.....

* Source: Standard Statistics Company, *Statistical Bulletin*, and *April Supplement, 1930.*

The years 1927, 1928, and 1929 were not profitable ones for either of these concerns because of the depressed condition of the textile industry. When the 1929 statements, as shown in Exhibit 2, were received by the Bayou Bank & Trust Company, one of its officers remarked that he believed the Delta Cotton Company would bear careful watching in the future, but made no particular comment on Lewis & Cates. Another officer

of the bank stated that the loans of each company were amply secured at the prevailing prices for cotton, and that he considered the accommodation extended to the Delta Cotton Company to be fully as justifiable from the bank's point of view as that granted Lewis & Cates.

EXHIBIT 2

A. Financial Statements of Delta Cotton Company, as of December 31, 1927 to 1929*

	1927	1928	1929
Assets			
Cash	$ 46,558	$ 25,545	$ 38,909
Accounts Receivable	293,899	382,439	361,996
Merchandise	869,928	1,348,468	727,729
Current Assets	$1,210,385	$1,756,452	$1,128,634
Automobiles	1,064	2,533	2,001
Exchange Seat	32,200	32,200	32,200
Other Assets	....	3,406	9,110
Total Assets	$1,243,649	$1,794,591	$1,171,945
Liabilities			
Notes Payable—Banks	$ 150,000	$ 290,000	$ 100,000
Accounts Payable	335,136	219,460	96,290
Acceptances Payable—Hedging Account	207,250	160,044	150,010
Acceptances Payable	243,329	867,170	711,719
Current Liabilities	$ 935,715	$1,536,674	$1,058,019
Common Stock	300,000	300,000	300,000
Surplus	7,934	42,083(d)	186,074(d)
Total Liabilities	$1,243,649	$1,794,591	$1,171,945
Current Ratio	1.29–1	1.14–1	1.06–1
Net Worth—Debt	.32–1	.16–1	.10–1
Merchandise—Receivables	2.95–1	3.52–1	2.01–1
Acid Test	.36–1	.26–1	.37–1

* Audited.
(d) Deficit.

EXHIBIT 2. (*Continued*)

B. Financial Statements of Lewis & Cates, as of December 31, 1927 to 1929*

	1927	1928	1929
Assets			
Cash	$1,111,457	$ 859,396	$ 798,865
Accounts Receivable	2,337,483	1,868,542	1,571,318
Merchandise	214,801	510,284	204,211
Current Assets	$3,663,741	$3,238,222	$2,574,394
Furniture and Fixtures	10,676	12,175	17,116
Investments	67,470	46,526	32,732
Other Assets	42,208	43,619	146,187
Total Assets	$3,784,095	$3,340,542	$2,770,429
Liabilities			
Time Drafts on Cotton	$ 357,500	$ 553,713	....
Accounts Payable	496,099	215,642	$ 225,571
Sundries and Accruals	147,428	11,577	38,267
Demand Notes	1,021,084	1,116,884	1,446,397
Drafts and Acceptances	549,657	343,713	89,573
Current Liabilities	$2,571,768	$2,241,529	$1,799,808
Preferred Stock	900,000	900,000	900,000
Common Stock	100,000	100,000	100,000
Surplus	212,327	99,013	29,379(d)
Total Liabilities	$3,784,095	$3,340,542	$2,770,429
Current Ratio	1.42–1	1.44–1	1.43–1
Net Worth—Debt	.47–1	.49–1	.53–1
Merchandise—Receivables	.09–1	.27–1	.12–1
Acid Test	1.34–1	1.21–1	1.31–1

* Audited.
(d) Deficit.

Do the facts presented warrant a change in the lending policy of the bank?

Should a bank make any commodity-secured loans, knowing that their collection will force the borrower out of business?

What is the minimum net worth to debt ratio that should be countenanced for any borrower?

8. COLLATERAL-SECURED LOANS

LORRIMER NATIONAL BANK

LOANS ON SECURITIES AS COLLATERAL—TO INDIVIDUALS[1]

The Lorrimer National Bank was the largest banking institution in a northern New York city. On July 31, 1929, the bank's loans to individuals secured by the pledge of bonds and stocks had reached the highest point on record. The growth in these loans had been continuous since 1924, but the rate of increase had been accentuated in 1928 and 1929. Although Mr. Jenkins, the officer in charge of this class of loans, did not know in all instances the purposes of the borrowers, he believed that in the majority of cases the proceeds were used for the speculative purchase of stocks. A number of these borrowers used bank loans in preference to margin accounts, exchanging collateral frequently as they bought and sold stocks. As a matter of policy, Mr. Jenkins endeavored to discover the reason why each loan was desired, but with some individuals this was impossible. The other reasons for which individuals contracted loans were numerous. Some borrowed for purchase of investment securities. In these cases the loans were paid off either gradually, out of income, or in a lump sum, out of funds, the receipt of which was anticipated at the time of the loan. Other individuals borrowed to provide part of the purchase price of real estate, to make payments on automobiles, to finance the education of their children, and for various personal needs. The average size of the loans outstanding on July 31, 1929, was $9,000, and 60% of the loans were for $5,000 or less.

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[1] References for use in cases presenting loans on securities as collateral:
Meeker, J. E., *The Work of the Stock Exchange*, revised edition, Ch. XI, pp. 275–310, Appendix, pp. 619–635, and References, pp. 682–683; Westerfield, R. B., *Banking Principles and Practice*, revised printing, pp. 551–570; Hollander, J. H., "Bank Loans and Stock Exchange Speculation," *National Monetary Commission*, Sen. Doc 589, 61st Congress, 2nd session; Dice, C. A., *The Stock Market*, Ch. XXV; Kniffin, W. H., Jr., *The Practical Work of a Bank*, eighth edition; Pratt, S. S., *The Work of Wall Street*, third edition; Kilborne and Woodworth, *Principles of Money and Banking*, fourth edition; Harr and Harris, *Banking Theory and Practice*, second edition, pp. 175–183.

Loans to individuals on securities were similar in some respects to brokers' loans. The same general principles held in regard to the watching and handling of collateral and the requirements on margins. Loans to individuals, however, were not as liquid and, although many such loans were drawn on demand, the Lorrimer National Bank preferred that individuals borrow on time. As a result, the greater part of these loans had definite maturity dates. Demand loans to individuals tended to become perpetual loans, whereas time loans gave the bank the opportunity of reviewing the situation and of considering whether the loan should be renewed, reduced, or refused. The policy of the Lorrimer National Bank was more strict than that of the smaller banks in the same city. A loan was never made to a nondepositor, and a borrower was not expected to borrow more than five times his average balance. No personal statements were required, but a credit file was kept containing data in regard to the profitability of the account itself, connection with other depositors and with commercial customers, extent to which the borrower used the other departments of the bank (trust, investment, etc.), the borrowers' general financial standing, and the opinions of the officers concerning the borrower. No credit information was available on depositors who were not borrowers.

During the latter part of 1928 and in 1929, because of the conditions in the money and stock markets, the Lorrimer National Bank had endeavored to discourage its depositors from borrowing to purchase stocks. Thereby the bank was following the principles accepted by the majority of bankers and by the Federal reserve authorities, namely, that bank credit to finance the purchase of securities should be restricted in so far as necessary to conserve banking resources for the legitimate demands of commerce and industry. The measures adopted to carry out this policy included high rates on security loans, enforcement of the provision concerning the maintenance of balances, high margin requirements, the drastic downward revaluation of stocks offered as collateral, moral suasion, and, in some cases, direct refusal to loan. In July, 1929, interest rates on individual loans varied from 5½% to 7%, and margins of 40% were required on New York Stock Exchange collateral. Many stocks were marked down to what seemed at the time to be fair values before this percentage was applied. Despite these measures to curtail such loans, the total continued to grow; and, on July 31, 1929, three depositors applied

to Mr. Jenkins for loans based upon stocks and bonds as collateral.

Joseph F. LeRoy, president and general manager of the LeRoy Knitting Mills, Incorporated, asked for a 90-day loan of $50,000 on the security of 500 shares of the common stock of the LeRoy Knitting Mills. Mr. LeRoy was the son of the founder of that enterprise and had succeeded to his present position at his father's death. He was 45 years old and was looked upon as an able business man. He had a reputation as a sportsman and as a lavish entertainer. He had maintained an account at the bank for eight years, but never before had asked for a loan. Deposits in the account were large, but these were quickly checked out and the average balance was about $1,500. Mr. Jenkins believed that Mr. LeRoy did not save any of his income, and he knew that the mill man speculated on margin through a local brokerage firm. Mr. LeRoy was unwilling to disclose his purpose in asking for a loan, and the bank officer assumed that it would be used for the purchase of stocks.

The LeRoy Knitting Mills, Incorporated, had been established in 1901 and, although not a large unit in the industry, had an excellent standing. Its product also was well known. The line consisted of medium-grade cotton, silk, and rayon underwear for women. Prior to 1923 annual sales had averaged about $4,000,000, but shifting conditions within the industry, because of new buying methods and style changes with which the mill had not been able to cope, had cut their volume approximately in half. Recently the sales had shown an increase. Earnings were somewhat larger than reported, because of the policy of paying large salaries to the four members of the LeRoy family who were active in the management. With the exception of three small lots owned by old employees, all the stock of the corporation was owned by the LeRoy family. No stock had ever been sold, and there was no apparent market for it. The mill had a line of credit with the Lorrimer National Bank for $100,000, none of which it was using at that time. The average balance in the account was $30,000, and the bank handled the corporation's payroll account. The company had another account with a bank in New York City. The credit folder for the LeRoy Knitting Mills included the information shown in Exhibit 1.

Dr. L. O. Brenkton requested a loan of $10,000. He suggested that it be on demand since he expected to be able to repay it in a

EXHIBIT 1

Financial Statement of LeRoy Knitting Mills, Incorporated, as of December 31, 1928

Assets	
Land and Buildings	$1,444,000
Other Assets	210,000
Deferred Charges	40,000
Cash	92,000
Notes and Accounts Receivable	227,000
Inventories	470,000
	$2,483,000
Liabilities	
Capital Stock (6,000 shares)	$ 600,000
Reserves	142,000
Profit and Loss Surplus	1,575,000
Accounts and Notes Payable	120,000
Accrued Interest and Taxes	46,000
	$2,483,000

	1926	1927	1928
Sales	$2,397,000	$1,976,000	$2,201,000
Net Profit	149,000	97,000	125,000
Dividends Paid	96,000	72,000	72,000

Sales for the first six months of 1929, $1,311,000.

relatively short time. Dr. Brenkton was a well-known dentist with an estimated annual income of $9,000. He had been a depositor in the Lorrimer National Bank for six years and had borrowed several times to purchase bonds. Previous loans had been for $2,000 to $3,000. He maintained an average balance of $1,200. In discussing the matter with Dr. Brenkton, Mr. Jenkins was told that the funds were to be used to purchase stock in two recently organized investment trusts. The doctor offered the following bonds as collateral:

Security	Closing Prices, July 30, 1929	Value
$2,000 American Smelting & Ref. 5's, 1947	101	$2,020
2,000 Consolidated Gas 5½'s, 1945	104½	2,090
3,000 Erie Refunding 5's, 1967	92¾	2,782
2,000 Missouri Pacific 5's, 1965	97	1,940
3,000 National Dairy Products 5¼'s, 1948	97⅛	2,913
1,000 Chicago, Rock Island & Pacific 4's, 1934	93¾	937
1,000 Penn. 7's, 1930	101¼	1,012

Mr. Alexander Craddock asked for a loan of $7,000 for six months on the following collateral:

Security	Closing Prices, July 30, 1929	Value
10 New York Central	229	$2,290
50 Buffalo Niagara & Eastern "A"	122	6,100
30 Rochester Gas & Electric, 7% Preferred	103 bid; 107 asked	3,090

Mr. Craddock was the proprietor of a small engraving and lithographing establishment. He had moved to the city from a smaller place three years before and had opened an account with the Lorrimer National Bank at that time. His business had prospered, his habits were simple, and apparently he had saved a considerable amount of money. He was very secretive about the condition of his business, however, and, although Mr. Jenkins knew that the proceeds of the loan would be used in the business, he did not know what type of expenditure Mr. Craddock was contemplating. Mr. Craddock had borrowed $5,000 in the same manner in 1928 and had paid the loan promptly upon maturity. His balance averaged $1,100.

What is the margin of security value offered as collateral to each of these loans? Is it satisfactory in each loan?

What motives do the respective borrowers have in requesting the loans? Is it important for a bank to know what use will be made of the funds, provided a satisfactory margin is maintained? Should financial statements be required of all borrowers on securities as collateral?

Which of the loans, if any, should have been made?

What should have been the terms of the loans, if made? Should stipulations be made as to balances to be maintained by such borrowers?

Should a bank volunteer to give forecasting advice on the future of stock prices to borrowers thought to be "in the market"? Should a bank give opinions thereon when asked?

Should a bank govern its lending policy as to collateral loans according to publicly announced warnings of the Federal Reserve Board and statements of economists as to the social desirability of further aid to speculation?

METACOMET NATIONAL BANK

LOANS ON SECURITIES AS COLLATERAL—TO BROKERS

The Metacomet National Bank of Boston was accustomed to making substantial loans to investment bankers and brokers who pledged securities as collateral. These loans were termed brokers' loans, and they were made by one officer of the bank, Mr. Patterson, who had several assistants working under him. It was the duty of these assistants to keep in touch with market conditions, both on the organized stock exchanges and on the open security markets in Boston and New York.

For the purpose of watching loans based upon listed securities, the assistants followed the daily quotations reported by the financial papers. The unlisted securities were followed by the most experienced of the assistants. This task involved visiting and talking with dealers in unlisted securities in Boston, and with speculators who bought and sold unlisted securities as well as those listed on the exchanges. Judgment of the value of unlisted securities required considerable skill. For example, the bank sometimes wished to revise the market value of an unlisted stock which it held as collateral and which had not been officially quoted for several months. The determination of its value, therefore, had to be based upon a careful investigation of the condition of the company and the industry involved. The market value was then approximated.

Whenever the value of securities pledged declined, the borrowers were notified to provide additional collateral. Securities could be withdrawn and others substituted, provided the new securities were approved. The margin between the value of the collateral and the amount of the loans made varied widely, depending upon the following factors: (1) classes of securities, such as bonds, notes, preferred or common stocks; (2) marketability, which involved the status as to listing, number, and frequency of sales, spread between the bid and asked prices, and speculative and investment interest in the securities; (3) diversification of the collateral; (4) industries or fields represented, as, for example, rails, utilities, industrials, governments, etc.; (5) condition of the individ-

ual companies; (6) the number of shares in the various lots of stock and the selling prices of the different issues; (7) general market conditions; (8) the financial standing of the borrower.

Under ordinary conditions, on loans secured by mixed stock exchange collateral, banks usually required a margin of 25% to 30% of the amount of the loan granted. Before the stock market collapse in October and November, 1929, a margin of 40% was customary, but, after the second of the three bad breaks, several banks reduced this amount to 25%. This move was warranted by the lower security prices and, incidentally, served to inspire confidence and to encourage the purchase and holding of stocks. Also it removed the necessity for banks to press those borrowers whose margins, even after frequent deposits of additional collateral, had shrunk to nearly 25%. At times, individual stocks or groups of stocks which banks considered overvalued were arbitrarily marked down in valuation as collateral for loans. For example, during the summer of 1929, when public utilities reached prices 30 to 50 times published earnings, a bank would revalue such stocks at 20 times earnings and then require the customary margin on the basis of the new price. One of the remedies, since proposed, to prevent a recurrence of such inflation in stock prices, was that banks should limit stock values for loan purposes to 10 times earnings, regardless of market prices. The Metacomet National Bank always had been conservative in its margin requirements.

Loans to brokers were divided into call loans and time loans. The former were payable on demand and were renewed from day to day, while the latter had definite maturity dates. A sharp distinction had to be drawn, however, between call loans to brokers who were customers and those to brokers who were not otherwise connected with the bank. The noncustomer loans were truly quick, whereas the customer loans, although theoretically on demand, had to be handled with due consideration for the interests of the customer. The majority of brokers' loans made by the Metacomet National Bank were on call, and a large part of these were placed in New York.

The making of New York call loans was a relatively simple matter. Mr. Patterson directed the New York correspondent bank to loan a certain sum on call, and the correspondent bank arranged the rate and margins and was responsible for the handling of the collateral. When the loan was confirmed, the Meta-

comet National Bank also received the name of the borrowing broker or brokers and a list of the collateral. The bank was informed also of all substitutions. The demand and supply for call loans in New York were nicely adjusted, and the posted rate on the Exchange usually indicated the true condition of the market. The rate on new call loans varied during the day, but that on renewals once posted remained fixed until the next day. As a matter of routine, renewals were handled by the New York correspondent. The rates on time loans depended upon the continued need for funds and upon the market's forecast for interest rates during the ensuing few months.

The rates for loans to brokers in Boston followed those in New York. There were, however, certain points of difference. In Boston, call loans were usually renewed at the original rate rather than at that for the day, and variations in the collateral offered and in the financial standing of the borrowers resulted in departures from uniformity. This fact was especially true of loans to broker customers and was also true of loans by New York banks to their own broker customers. The Metacomet National Bank, for example, had agreed with two broker customers early in 1929 to limit rates on their loans to 6%, and to give them the benefit of any rates below that figure. These brokers were customers of long standing; they had maintained ample balances; and in several cases, the partners had been instrumental in securing new business for the bank. The rate on call loans to broker customers was ordinarily ½ of 1% above the market rate on quick call loans.

At the close of business on February 24, 1930, the Metacomet National Bank had loans outstanding to brokers of $3,420,000, of which $1,110,000 was on time and the remainder on call. The latter were divided into $990,000 to broker customers in Boston, $160,000 to outside brokers in that city, and $1,160,000 in the New York market.

On the morning of the 25th, Mr. Patterson was advised that the bank would place at his disposal for investment on call $400,000 of additional funds, and he received three requests for new loans.

Amidon Brothers and Keswick wanted $500,000 which they expected to repay in about five days. This house was an old, established firm of investment bankers and brokers. For years they had dealt mainly in bonds, but during the last few years their stock business had expanded, and they had added a depart-

ment which carried margin accounts. Previously, although a membership in the Stock Exchange was owned, the firm had not accepted such accounts. This firm had been a customer of the bank for 27 years, and relations had always been satisfactory. The average balance was $120,000, and outstanding loans secured by New York Stock Exchange collateral totaled $340,000. The loan was needed to carry a block of municipal bonds until they could be sold and payment received from customers. These bonds were the general obligation of a large eastern city and were offered in various maturities at prices to yield from 4.10% to 4.35%. The amount offered by the syndicate, of which Amidon Brothers and Keswick was a member, totaled $4,500,000, and the par value of the firm's participation, all of which would be pledged as security for the loan, was $600,000.

Wayland & Waterman wanted a loan of $60,000 and offered as collateral the following:

Security	Prices at Close of Market, February 24, 1930	Value
50 Anaconda Copper	73¼	$ 3,662
50 Baltimore & Ohio	116⅛	5,806
50 Union Pacific	225	11,250
100 Electric Bond & Share	94½	9,450
100 New England Telephone & Telegraph	144½	14,450
400 Gillette	96½	38,600

The firm of Wayland & Waterman was established in 1926 and had gained a good reputation. The firm acted solely as broker and held memberships on both the Boston and New York exchanges. No organization was maintained in New York, a large New York brokerage house being used to execute all of the New York orders. During the market decline, Wayland & Waterman had answered margin calls promptly and suffered only a slight impairment of capital. Neither of the partners was a wealthy man, nor had they any connections which could be counted upon in the event of a need for additional capital. The partnership agreement prohibited the firm from taking a position in stocks.

In 1928 this firm had opened an account with the Metacomet National Bank, the balance averaging about $10,000. Borrow-

ings had been frequent in the past, but at the time of this request there were no outstanding loans.

S. T. Scotswold & Company wanted $120,000 on the security of the following stocks:

Security	Approximate Prices, as of Close of Market, February 24, 1930	Value
300 American Glue	56	$16,800
100 North Boston Lighting	86	8,600
100 Fitchburg Gas & Electric	59	5,900
100 Great Northern Paper	50	5,000
50 Merganthaler Linotype	108	5,400
50 Boston Elevated First Preferred	106	5,300
1,000 Quincy Mining	33	33,000
1,000 Heywood Wakefield	9	9,000
100 Ludlow Manufacturing	144	14,400
100 Pepperell Manufacturing	103	10,300
1,000 Greenfield Tap & Die	17	17,000
2,000 Massachusetts Utility Associates	9	18,000

This firm had been established in 1918. It was a member of the Boston Stock Exchange only, and dealt mainly in local and unlisted securities. Credit rating was not considered first class, and the firm was reputed to take part in various pool activities. In October and November heavy losses had been incurred, and new money had been put into the partnership. One of the two senior partners was reputed to be worth over $1,000,000, while one of the junior partners, who recently had been admitted to the firm, was the son-in-law of a prominent manufacturer. S. T. Scotswold & Company never had been a customer of the Metacomet National Bank, but had offered to open an account and to maintain an average balance of $30,000 provided the loan were granted. The firm had borrowed small amounts three times in 1928, and these transactions had been satisfactory from the bank's standpoint.

In addition to the three requests for new call loans, Mr. Patterson considered a request for the renewal of a collateral-secured time loan which matured that day.

Devon and Bristol, Incorporated, desired to renew, for another three months, a time loan maturing on February 25. This loan was for $65,000 and was secured at that time by the following collateral:

Security	Prices, as of February 24, 1930		Value
	Bid	Asked	
200 Providence-Washington Insurance	62	64	$12,400
100 Massachusetts Bonding & Insurance	125	135	12,500
50 Fidelity & Deposit	175	180	8,750
100 First National Bank of Boston	120	123	12,000
30 Guaranty Trust Company of New York	726	730	21,780
400 American Founders	25¾	26¾	10,300
200 United Founders	43¼(sale)		8,650

Devon and Bristol was incorporated in 1923 and specialized in insurance and bank stocks, later adding investment trusts. The standing of the firm was good, and it had been a customer of the bank for three years, maintaining an average balance of about $15,000. The present note was the result of two renewals, for the firm had been an almost continuous borrower since it had become a customer. Substitutions of collateral were frequent and, at the time of this latest request for a renewal, Devon and Bristol, Incorporated, wished to substitute 700 shares of American Founders and 100 shares of Providence-Washington for the 30 Guaranty Trust Company shares.

What decisions should Mr. Patterson have made in regard to: (*a*) granting the four requests for funds; (*b*) fixing the conditions upon which funds were to be loaned; (*c*) securing additional funds, if more than $400,000 was to be loaned?

Is there any vital difference between lending upon an inventory of finished goods and lending upon an inventory of unlisted securities which were purchased for resale?

Are there important differences between collateral-secured loans to individual customers, to broker customers, and to noncustomers?

Formulate a set of rules, or principles of lending, to be observed in making loans upon the security of stocks and bonds.

9. CONSUMER INSTALLMENT CREDITS

CAREY NATIONAL BANK

OPERATION OF A PERSONAL LOAN DEPARTMENT[1]

The Carey National Bank of Pittsburgh had capital and surplus of $17,500,000 and total deposits of $140,000,000 on December 31, 1930. The bank had been organized in 1902 and had grown rapidly under an aggressive management.

In March, 1929, the Carey National Bank had established a personal loan department, from which it hoped to obtain the following advantages:

1. Eliminating small loans from the regular loan department, thereby effecting savings in: (*a*) the time of loaning officers, since the details of operating the new department would be supervised by lower-salaried men; (*b*) clerical labor, through standardization of practice and the employment of specialized clerks; and (*c*) space cost, by locating the department adjacent to the savings department in the rear of the bank building.

2. Making small loans profitable by: (*a*) providing for serial repayment, thus increasing the rate of interest received; (*b*) cutting losses, by instituting a careful system of investigating risks and by securing co-makers on notes; and (*c*) handling a large volume of these loans.

3. Increasing the goodwill of the bank by: (*a*) soliciting sound, small loans, instead of refusing them because of inconvenience and expense; (*b*) increasing facilities for meeting the needs of all kinds of customers; and (*c*) performing the social function of accommodating deserving small borrowers who might otherwise be compelled to pay exorbitant rates of interest.

4. Securing new accounts for: (*a*) the savings department; and (*b*) other departments, if and when borrowers in the small loan department should develop into users of other services.

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[1] See: Brown and DeLano, "Commercial Banks and Small Loans," *Harvard Business Review*, Summer, 1938, pp. 481–490; Chapman, J. M., and Associates, *Commercial Banks as Agencies of Consumer Instalment Credits;* Foster, L. R., "Instalment Credit Costs and the Consumer," *Journal of Business of the University of Chicago*, January, 1935, pp. 27–45; Ryan, F. W., *Usury and Usury Laws;* Consumer Credit Institute of America, Inc., *Consumer Credit Bibliography;* American Bankers Association, Bulletin 74, *Survey of Personal Loan Department Experience and Practice.*

5. Advertising the bank

Mr. Phelps, the assistant cashier who was put in active charge of the personal loan department, had worked out the methods which were followed during the first two years of operation. Loans were made in amounts ranging from \$50 to \$1,000. There were two fundamental considerations involved in granting loans, namely, that the applicant have a sound reason for his borrowing, and that the applicant be steadily employed at a salary. Loans were made either against securities, with an average margin of 25%, or upon negotiable notes also signed by two co-makers, having incomes at least as large as that of the applicant and assuming liability, jointly and severally with the borrower, to meet payments on notes as they came due. All notes were discounted at 6% and were repayable either in 12 equal monthly installments or in 50 equal weekly installments. Although borrowers in the personal loan department almost invariably drew out the full amount of their loans as soon as granted, the operation of the serial repayment plan enabled the department to make loans having a face value approximately double the net amount of funds actually employed. Payments were made in the savings department and entered in an ordinary pass book. Interest at 3% was allowed on payments as made, and the amount of such interest was applied to opening a savings account in the name of the borrower when his loan was completely discharged. Thus, the rate of interest received by the department was approximately 9% on the net amount of funds in use. A rebate of interest was allowed on loans paid before maturity.

When a prospective borrower came to the small loan department, he was interviewed by Mr. Phelps or an assistant. During this interview an attempt was made to appraise the character of the applicant, and it was Mr. Phelps' opinion that this personal contact, although apparently superficial, was of great value in judging risks. The applicant was then given a form,[1] on which to supply information regarding his position, salary, other income, number of dependents, ownership of insurance policies and real estate, outstanding debts, previous dealings with loan companies, amount of rent paid, bank accounts carried, and trade references. On the same form there was space for information

[1] The information asked for on this form was similar to that in Exhibit 3 in the case of Garland National Bank, *infra.* For forms actually used by a personal loan department, see Federal Housing Administration, *Operating and Credit Manual.*

regarding the co-makers whose signatures would appear on the notes of applicants not borrowing against securities. When this form was returned to the personal loan department, properly filled out, it was turned over to one of the department's investigators. All statements made by the applicant were verified, the applicant's employer was interviewed, the assessed value of real estate owned was ascertained and the title was checked, trade and bank references were followed up, and past and present installment purchases or personal loans were carefully considered. The co-makers were also investigated. When the loan was to be collateral-secured, investigation was less searching.

Loans were approved or rejected on the basis of the interview, application blank, and investigation. When it was decided to make a loan, the borrower and co-makers executed a note payable to the order of the bank. The borrower was then given his money and was provided with a savings department pass book, a schedule of the dates and amounts of payments, and a slip showing the charges which would be made on delinquent payments.

When weekly payments became overdue, the following fines were imposed:

Amount of Payment	Daily Fine
$ 1– 5	$.10
6–10	.25
11–15	.50
16–20	.75

Fines on delinquent monthly installments were in proportion to those on weekly installments.

Although the note signed by the borrower and co-makers provided that, "In case any deposit shall not be made as herein agreed, this note shall, at the option of its holder, become immediately due and payable for the face amount thereof less any unearned discount," the bank made every effort to collect each installment. When a payment became three days overdue, a letter was sent to the borrower, followed, whenever necessary, by a second letter and a telephone call four days later. If these measures failed to produce results, the co-makers were notified ten days after the due date; if the delinquency continued for two weeks, the co-makers were requested to meet the payment. In the event that all other measures failed, the note was turned over to an attorney for collection in full, a charge of 15% of the amount remaining unpaid being added to defray the costs of collecting.

During the first two years of operation of the department, 3,024 loans, averaging \$301, were made. More than 85% of these loans were made on the endorsement of co-makers, the remainder being collateral-secured. In the same period 4,172 applications were received. Of this number, 2,679, or 64.2%, were granted after the regular examination; 345, or 8.3%, were granted after further investigation had been made or more acceptable co-makers had been secured; and 1,148, or 27.5%, were refused.

Of the 3,024 borrowers accommodated, 90% had made all payments promptly, 8% were slow on one or more payments but ultimately met all installments, while slightly less than 1.7% had had their notes turned over to attorneys for collection. The Carey National Bank found that a reserve of ½ of 1% of the face amount of all loans actually made was ample to care for losses.

Between March, 1929, and March, 1931, the direct and overhead expenses of the personal loan department averaged 9% of the net amount of money loaned. Consequently, the department had been operated at a small net loss.

The officers of the Carey National Bank were not satisfied with the results shown by the personal loan department, and in April, 1931, Mr. Phelps suggested certain modifications in the method of operation. These suggestions were as follows:

1. That payment of 3% interest on deposits of borrowers be discontinued. This device had been adopted in order to bring new business to the savings department. Two years of experience had shown that few savings accounts so created had remained with the bank. Amounts credited to borrowers in the personal loan department ranged from \$15 down to \$.75 and were apparently too small to give any impetus to the building up of savings accounts. A large percentage of these accounts were closed as soon as loans had been paid off.

2. That consideration be given to the possibility of making an investigation charge of ½ of 1% of the face amount of the loan application. This charge never had been inaugurated because of the possibility of a technical violation of the usury laws, but such a charge would make an important contribution to defraying the costs of investigation, particularly for those applications later refused. The amounts involved would be small enough not to repel prospective borrowers. If this charge were made and the crediting of interest on deposits were stopped, the personal loan department would receive a rate of 13% or more on the net

amount of money loaned out, instead of the 9% which had been realized in the past. Thus, the department would be able to show a profit of 3% or more per annum, which, on the average, would constitute a satisfactory return on the funds employed when considered in the light of the other advantages derived from the department.

3. That the possibility of allowing good customers of the bank to borrow small amounts through the regular loan department be considered. After the personal loan department had been organized, all applications for loans of $1,000 or less had been referred to it. On several occasions Mr. Phelps had talked with customers who had substantial checking accounts with the bank, but who wished to borrow a few hundred dollars in order to meet some temporary personal need. These customers had objected to making serial repayments since, in many cases, they desired accommodation for only three to six months and wished to discharge their indebtedness in one lump sum. They objected also to submitting a formal application and to the type of investigation made by the department. Consequently, Mr. Phelps believed that an inflexible rule regarding the loaning of small amounts through the personal loan department might be creating ill will for the bank among this class of customers.

4. That some arbitrary limit be placed on the number of successive loans which one individual might obtain from the department. Renewals were not permitted in the personal loan department, but at first there had seemed to be no objection to relending immediately when the customary investigation showed a request for such accommodation to be reasonable and the risk to be good. Approximately 50% of the department's business during 1930, however, had been in loans to persons who had borrowed in 1929, and it seemed desirable to formulate some rule which would prevent loans from becoming permanent, regardless of their apparent soundness.

What class of persons makes the most desirable customers for a personal loan department?

What definite relationship, if any, exists between the salary of an applicant and the amount of the accommodation which should be extended?

Should large commercial banks establish personal loan departments?

GARLAND NATIONAL BANK

FINANCING OF AUTOMOBILE DEALERS BY A COMMERCIAL BANK[1]

In the early days of the automobile industry in the United States, one of the prominent manufacturers in this field approached several of its depository banks in the hope of securing aid for its dealers in financing their purchases of cars and their sales to the public. At that time, the majority of automobile manufacturers had scarcely enough capital to finance the production schedules which were necessary in order to keep pace with a rapidly growing demand for their product. They, consequently, were reluctant to carry the receivables of their distributors for any length of time. The distributors, in turn, were largely carriage or bicycle dealers, whose limited capital made it impossible for them to make payment on cars before they were bought and paid for by the ultimate purchasers.

One of the few banks which responded to this particular request for aid in financing dealers was the Garland National Bank, a prominent St. Louis institution. It did so merely as an accommodation to a good customer, taking dealers' and retail purchasers' notes for two-thirds of the value of cars and charging the customary interest rate.

This early entrance of the Garland National Bank into the field of automobile financing gave it a reputation in the Southwest, and other manufacturers soon came to it for a similar service. During 1918 the bank organized an installment sales department and began to seek this type of business as an added source of profit. The bank believed that its credit department should not be burdened with the supervision of loans to dealers to whom it would not lend on the strength of their statements alone. The credit work of the installment sales department, therefore, was

[1] References for use in this case and subsequent cases on automobile credits: Seligman, E. R. A., *The Economics of Instalment Selling;* Grimes, W. A., *Financing Automobile Sales;* the case, Automobile Finance Corporation, *Harvard Business Reports*, Vol. VII, pp. 346–351; Harris, C. D., "Why Spurn Installment Loans?" *American Bankers Association Journal*, August, 1930, pp. 89–91; *Federal Reserve Bulletin*, January, 1923, pp. 37–45, reprinted in Nelson, M. N., *Readings in Corporation Finance*, pp. 396–413.

carried on independently of the commercial loan department. The new department was similar to a finance company in every respect, except that it obtained its capital from the deposits of the bank instead of borrowing from outside sources.

In the summer of 1930 a representative of the company which distributed Nash cars in the St. Louis district told one of the officers of the installment sales department of the Garland National Bank that a new dealer agency, the Milliken-Nash Company, was being established in Junction City, a near-by town of 20,000 inhabitants. This new Nash dealer had previously handled the cars of a manufacturer having a subsidiary finance company, but had made no arrangements for financing since obtaining the Nash agency.

The installment sales department immediately sent a representative to Junction City to attempt to secure this business. He reported that the Milliken-Nash Company owned one of the finest garages in the vicinity, and had built up a good clientele with its previous agency. He stated that Mr. N. T. Milliken, the president of the concern, had shown immediate interest in the installment sales department's "No Recourse" retail plan,[1] and

[1] The installment sales department of the Garland National Bank offered three retail plans to dealers. Financing charges under each of these plans varied with the amount due from the retail purchaser in the form of installments (that is, the total cash selling price less the amount of the down payment—see Exhibit 3) on any individual car. For example, under the "No Recourse" plan, the charge on a balance due of \$300 was \$40, or 13⅓%; on a balance of \$1,000 it was \$110, or 11%; on a balance of \$2,000 it was \$180, or 9%. The reason for this variation lay in the fact that certain expenses, such as the investigation of retail purchasers as credit risks and the making of collections, remained fixed and resulted in a higher percentage charge when applied to a small amount of financing than when applied to a large amount. The essential features of the bank's three retail plans were as follows:

(*a*) *No Recourse.*—The dealer's responsibility ends when a car is sold. The bank makes all collections and, in the event that repossession is necessary, has only the car to look to in order to make up the amount of unpaid installments. This is the plan most commonly used by dealers.

(*b*) *Repurchase.*—The bank makes collections from the retail purchaser, but if repossession is necessary the bank turns the car back to the dealer instead of disposing of it. The dealer then reconditions and resells the car, returning to the bank the amount of the unpaid installments, or the entire resale price if it does not equal the balance due. Although the price of financing is the same to the ultimate purchaser under this plan as under the "No Recourse" plan, the dealer receives a small rebate from the bank when installments have been paid in full. This amount is set up by the bank as a so-called "Dealers' Reserve," which it can look to if the resale price of the car does not equal the amount due, but which otherwise is returned to the dealer for his services in reselling the vehicle.

(*c*) *Recourse.*—The bank makes collections, but the dealer agrees to make good all unpaid installments in the event of repossession. The same rebate to dealers made under the "Repurchase" plan is operative under this plan if installments are paid in full. The bank demands recourse against dealers who are willing to assume some responsibility, and with whom it anticipates possible difficulty in collecting unpaid installments.

EXHIBIT 1

Financial Statement of, and Information Concerning, the Milliken-Nash Company, as of June 30, 1930

Statement of—*Milliken-Nash Company*	Trade References
Address—*180 Main Street, Junction City, Missouri*	*St. Louis-Nash Company, St. Louis, Mo.*
Individual Partnership Corporation *X*	*J. I. Case Company, St. Louis, Mo.*
Names and Addresses of Partners or Officers	How Much Insurance Did You Carry at Date of Statement:
N. T. Milliken, Pres., Junction City, Mo.	On Automobiles—*$36,000*
Frank Milliken, Sec'y and Treas., Junction City, Mo.	On Buildings—*$18,000*
Make or Makes of Cars Handled—*Nash*	On Other Merchandise—*$7,200*
Number of Cars Contracted for This Year—*None*	Authorized Capital—*$15,000*
Number Sold Last Year: New—*156;* Used—*289*	Amount Paid In—*$3,600*
Bank Accounts—*Bank of Junction City*	

Assets			Liabilities		
Current			Current		
Cash on Hand and in Banks		*$ 3,673*	Accounts Payable		
Accounts Receivable			Customers' Deposits		
For Storage and Accessories			Creditors' Accounts	*$13,446*	
Other	*$19,687*	*19,687*	Dividends Payable	*210*	*$13,656*
Notes Receivable			Notes Payable		
Automobile Sales			For Automobiles	*$19,440*	
Other	*$ 3,918*		To Banks—Unsecured	*5,400*	
Less Doubtful		*3,918*	Secured		
Inventories			Endorsed		
New Cars at Cost	*$22,737*		To Others	*5,088*	*29,928*
Used Cars	*12,827*				
Parts and Accessories	*9,300*		Advances by Officers and Employees		
Gas and Oil	*574*		Accruals		
Other Merchandise (Describe)			Payrolls		
Used Truck	*692*		Taxes	*$ 834*	
Farm Implements	*6,186*	*52,316*	Rent		

Deposits with Manufacturer or Distributor		360
Securities		
Total Current		$ 79,954
Fixed		
Investments (Describe)		
Mortgage Receivable	$ 9,600	
Additional Discount Due from Distributor	371	9,971
Prepaid Expenses		
Insurance	$ 73	
Licenses	302	
Accrued Interest	256	631
Advances to Officers and Employees		
Land and Buildings	$59,417	
Less Depreciation	2,759	56,658
Machinery and Equipment	$ 3,575	
Furniture and Fixtures	1,165	
Less Depreciation	1,774	2,966
Other Assets (Describe)		
Wrecking Cars	$ 1,170	
Cash Value of Life Insurance	2,026	3,196
Total Assets		$153,376

Interest	300	
Insurance	157	1,291
Total Current		$ 44,875
Fixed		
Mortgages on Real Estate		$ 19,410
Mortgages on Equipment		
Reserves		
Bad Debts	$ 388	
Valuation of Used Cars	7,500	
Obsolete Parts	300	8,188
Capital or Net Worth		3,600
Surplus		77,303
Total Liabilities		$153,376

We hereby submit the foregoing as being a true and correct statement of our financial condition as of *June 30, 1930.*

Signed: *Milliken-Nash Company*
by *N. T. Milliken, President*

in obtaining wholesale financing at the rate of 6% a year plus the bank's usual service charge,[1] and had agreed to do business with the Garland National Bank in the event that it approved the financial statement made out on the installment sales department's form, which is reproduced in Exhibit 1.

After analyzing the Milliken-Nash Company's statement and noting the other information given in Exhibit 1, the installment sales department obtained the following reports on the concern:

Commercial Agency Report.—This business has been in operation for some years and was incorporated as a Missouri corporation during 1928, the present name being taken in June, 1930.

The company has never released detailed statements of its financial condition, the only figures available being those furnished to the Secretary of State of Missouri. It is believed, however, that expenses are rather heavy, indebtedness fairly high, and progress at this time doubtful. Authorized capital stock is $15,000.

The company occupies two brick buildings and appears to do quite a large business. It has heretofore been the local agent for Buick cars and Case agricultural implements, but it is understood to be contemplating a change in its automobile agency. Satisfactory banking connections are maintained.

Retail Credit Bureau Report.—The opinion of local informants is that the Milliken brothers are reliable and honorable, and would not contract obligations which they were not able to meet.

They have made a good record in the garage business for several years, and appear to be of good repute in the community. Their outside worth is conservatively estimated at $75,000. N. T. Milliken is also president of the Milliken Lumber Company.

Checking with the Bank of Junction City.—We have loaned to this company on their unsecured note from time to time for several years, and our experience has always been satisfactory. Maximum borrowings have been $7,500.

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[1] The amount of this service charge varied widely, but in the case of most dealers it amounted to approximately ¼ of 1% per month on the amount loaned. Some 85% to 90% of the financing which the installment sales department did was under its retail plans, and it was this branch of the business from which the department derived nearly all its profit. Aid in financing the wholesale purchase of cars was extended more as an accommodation to retailer customers than for any other reason, and consequently the bank felt justified in varying its wholesale service charge in an inverse relation to the volume of retail business given it.

One specific item which the service charge covered was the cost of recording chattel mortgages in the bank's favor on cars on the dealer's floor.

Both the Milliken brothers are depositors of ours, and we entertain the highest opinion of their ability and integrity.

In order to check up on the statement made in the commercial agency report that "it is believed progress at this time is doubtful," the Garland National Bank wrote to the Milliken-Nash Company for its last previous statement, and received the balance sheet shown in Exhibit 2.

EXHIBIT 2

Balance Sheet of the Milliken-Nash Company, as of January 1, 1929

Assets		Liabilities	
Cash	$ 1,204	Accounts Payable	$ 11,642
Accounts Receivable	12,206	Notes Payable	2,290
Notes Receivable	5,792	Notes Payable—Banks	5,580
Inventories	25,784	Due Officers	2,863
Mortgage Receivable	13,200	Mortgage on Real Estate	18,000
Prepaid Insurance	619	Reserves	359
Land and Buildings	51,612	Capital Stock	2,400
Machinery and Equipment	4,063	Surplus	72,426
Cash Value Life Insurance	1,080		
Total	$115,560	Total	$115,560

On August 5 the vice president in charge of the installment sales department of the Garland National Bank wrote to Mr. N. T. Milliken, as follows:

Dear Mr. Milliken:

We are pleased to advise you that the Garland National Bank has approved your application for both wholesale and retail financing of Nash Cars.

In regard to the wholesale end, we shall be glad to extend you any reasonable amount of credit on the following described terms. We shall advance 90% of the manufacturer's price of cars, you to pay interest at the rate of 6% per annum and our customary service charge of ¼ of 1% per month. Payment on these wholesale notes must be made within four months, unless we agree to an extension of two additional months. In the latter case, renewal may be contingent on a reduction of the amount loaned on each car which remains unsold. You will readily understand that wholesale notes must be paid off as retail sales are made, so that title to the sold car may then pass from us to you. As I believe you know, we make it a practice to send investigators to each of our wholesale customers once every two weeks. It is the duty of these

men to check up all our cars on the dealer's floor in order to be sure that no sales have escaped our attention and that all cars are in good condition.

When you wish to make a retail sale on our installment financing plan, you will be required to telephone or write this office in order to supply us with information regarding the prospective purchaser, such as that contained on the enclosed sample Purchaser's Statement (see Exhibit 3). If we approve the sale we will advise you at once, and as soon as our wholesale note on the car in question has been paid, we

EXHIBIT 3

Purchaser's Statement

THE GARLAND NATIONAL BANK
Installment Sales Department

Name of Dealer *Milliken-Nash Company*

For the purpose of securing credit from you in the purchase of the Motor Vehicle mentioned in the contract signed by me and in order that you may sell to or discount with the Garland National Bank the note mentioned therein, undersigned makes the following representations:

Corporation Individual *X* Partnership (Indicate with X)

Date *January 1, 1930*

Print Name	*John Doe*	Home Telephone No.	*City 3456*
Home Address	*306 Broadway, Junction City, Mo.*	How long there	*7 yrs.*
Previous Address	*508 Allen St., Junction City, Mo.*	How long there	*4 yrs.*
Employed by	*National Mfg. Co.*	How long there	*6 yrs.*
Address	*25 A Street, Junction City, Mo.*	Telephone No.	*City 2345*
Kind of Business	*Foreman—Dye House*	Monthly Income	*$400.00*
Previous Employer	*U. S. Mfg. Co.*	How long there	*10 yrs.*
Address	*33 Long St.*		

Age *42* If under 24 Years Give Date of Birth—And Where Born *St. Louis, Mo.*

Nationality *American* Married or Single *Married* No. of Dependents *2*

Nearest Relative NOT Living with You *James Doe* Address *44 Pine St., City*

Other Income *Yes* From What Source Received *Rents*

Savings or Checking Account with *The Bank of Junction City*

In Whose Name *John Doe* Pass Book Number *678*

Real Estate and in Whose Name *Yes* Cash Value *$25,000.00*

John and Mary Doe

Located at *306 Broadway, Junction City, Mo.* Total Mortgage *$5,000.00*

If You Have Purchased Car Before Give Name of Dealer *Milliken-Nash Co.*

Date Purchased *4/25/28*

At What Bank or Finance Company Did You Make Payments?

Garland National Bank

Business references: *Corner Grocery*

Address *C Street, Junction City, Mo.* Telephone No. *City 9730*

Car will be Garaged at *306 Broadway, City*

Will be Used for Pleasure *X*
Business
Passenger Hire

EXHIBIT 3. *(Continued)*

Make of Car			Type of Body	Year and Model	Number Cyl-inders	Manufacturer's Serial Number	Motor Number	Tons Capacity
New	Used	Demonstrator						
Nash			*Sedan*	*433* *1930*	*6*	*162–946*	*1m98765*	

A. List Price	*$1,300.00*	G. Cash Payment	*$ 200.00*
B. Freight, Tax, and Delivery Charge	*120.00*	H. Trade In: Allowance on Motor Vehicle Traded in	
C. Extra Equipment (Itemized Below)		Date *Jan. 1st., 1930*	
Special Head Lights	*30.00*	Make and Type *Chevrolet Coupe*	*300.00*
Trunk	*50.00*	Motor Number *987654*	
		Year *1927*	
D. Total Cash Selling Price	*$1,500.00*	I. Total Initial Payment (33⅓%)	*$ 500.00*
E. Finance Discount	*110.00*	J. Balance Due:	
		one Installment at *$98.00*	*1,110.00*
		eleven Installments at *92.00*	
F. Total Time Price	*$1,610.00*	K. Total Time Price	*$1,610.00*

Salesman *A. M. Smart*

John Doe
Purchaser's Signature

EXHIBIT 4

Purchaser's Note

GARLAND NATIONAL BANK

$1,110.00

St. Louis, Mo., January 1, 1930

For value received the undersigned promises to pay to the order of

Milliken-Nash Company
(Dealer)

One thousand one hundred ten and ~~~~~~~~~~~~ $\frac{00}{100}$, Dollars

payable at The Garland National Bank, the first installment one month after date and the remaining installments to be paid in consecutive monthly payments, with interest after maturity at 6% per annum.

In case of any default on part of the maker, the holder may immediately demand payment hereof, and all installments unpaid shall then become due and payable, anything to the contrary herein notwithstanding, and the maker will immediately pay the same, and also the maker agrees to pay all expenses of collection including attorney's fees and disbursements.

MONTHLY INSTALLMENTS

1 Inst'l @ *$98.00*

11 Inst'ls @ *$92.00*

John Doe
(Signature)

No. *306* Street *Broadway* City or Town *Junction City* State *Missouri*

Dealer's Endorsement (appearing on reverse side of Purchaser's Note)

Pay to the Order of
THE GARLAND NATIONAL BANK
without recourse

Milliken-Nash Company
(Dealer)

By *N. T. Milliken, President*
(Title)

will send you our check for the total time price less the amount of the total initial payment and our financing charge, and we will discharge the chattel mortgage. The down payment, including the allowance made on trade-ins, must in no case be less than 33⅓% of the total cash selling price (*i.e.*, Item D on the description of car). Under the "No Recourse" plan which you wish to use, our financing charge, which includes the full insurance which we carry against fire and theft, varies from 9% to 13%, depending on the amount of the balance due after the purchaser makes his initial payment. This financing charge will be included in the installment payments due from the purchaser.

As a user of our "No Recourse" plan, you are to send us the conditional sales agreement under which you allow the retail purchaser to take possession of the car. You are also to fill out on the reverse side of this agreement the Dealer's Assignment whereby you transfer to the Garland National Bank your interest in the vehicle. Finally, you are to send us the retail purchaser's note, a sample of which is enclosed (see Exhibit 4), endorsed to us without recourse.

Hoping that the above will make clear our method of operation and thanking you for your patronage, we are

Very truly yours,

GARLAND NATIONAL BANK

by H. A. CURRAN, Vice President

Criticize fully the policy of the Garland National Bank in establishing its installment sales department and in using a considerable portion of its deposits to finance the sale of automobiles.

Appraise the value or the adequacy of the security furnished the installment sales department in its wholesale financing activities and under its various retail plans.

Was the Milliken-Nash Company a desirable dealer for whom to do this type of financing?

MADDEN FINANCE COMPANY

PURCHASE OF THE PAPER OF AN INSTALLMENT FINANCE COMPANY[1]

On April 28, 1930, Mr. W. S. Jeffries, the cashier of the Citizens National Bank in an eastern Iowa town of 15,000 inhabitants, was approached by a salesman of a well-known commercial-paper house in Chicago. Among the names which he had to offer, the salesman laid particular stress on that of the Madden Finance Company, a Chicago concern which did a general financing business, and whose paper was selling to yield 4¾% in comparison with an average rate of 4% on the prime industrial and commercial names on his list of offerings.

Aside from the financial statements of the Madden Finance Company for the years 1927, 1928, and 1929, shown in Exhibit 1, the salesman could furnish Mr. Jeffries with little detailed information regarding the concern. He was able to tell him that the company did not purchase open accounts, and that the accounts receivable shown on its balance sheets arose largely from retail sales of automobiles and electrical appliances and from the discounting of the notes of other smaller finance companies. He stated also that the house which he represented thought highly of the management of the Madden Finance Company, and that a partner in the firm had been on its board of directors for some time.

Although Mr. Jeffries was not satisfied with this meager information, he was interested in the offering because of the relatively high rate which it bore at a time when money rates were low and it appeared probable that they would soften still further. Consequently, he agreed to buy $10,000 worth of the company's 120-day paper on a 10-day option, which would allow him time to obtain further facts regarding the Madden Finance Company, and to discuss the proposed purchase with the other officers of the bank before definitely approving or rejecting the commitment.

[1] For another case, see McKinley National Bank, Ebersole, J. F., *op. cit.*, first edition, pp. 175–179. For a discussion of buying commercial paper on option, see Kniffin, W. H., Jr., *The Practical Work of a Bank*, eighth edition.

EXHIBIT 1

Financial Statement of the Madden Finance Company, as of December 31

	1927	1928	1929
Assets			
Cash	$ 595,804	$ 618,608	$ 900,587
Motor Lien and Other Installment Notes, Less Reserves	4,279,845	7,578,444	6,612,017
Repossessed Cars	5,844	4,443	18,000
Sundry Accounts Receivable	9,300	6,410	2,295
Marketable Securities	....	9,750	4,875
Due from Commercial-paper Brokers	....	12,500	....
Current Assets	$4,890,793	$ 8,230,155	$ 7,537,774
Cash Value Life Insurance	....	....	1,814
Preferred Stock Retirement Fund	131	38,080	27,215
Furniture and Fixtures	14,489	15,367	18,861
Prepayments	25,410	82,973	81,085
Total Assets	$4,930,823	$ 8,366,575	$ 7,666,749
Liabilities			
Notes Payable—Banks and Brokers	$2,620,625	$ 5,905,625	$ 5,233,375
Accounts Payable	85,084	100,059	87,801
Current Liabilities	$2,705,709	$ 6,005,684	$ 5,321,176
Reserve for Losses	50,000	50,000	50,000
Deferred Credits	180,597	293,176	292,481
Preferred Stock	759,000	759,000	715,625
Common Stock and Surplus	1,235,517	1,258,715	1,287,467
Total Liabilities	$4,930,823	$ 8,366,575	$ 7,666,749
Gross Receivables Purchased	$7,985,434	$13,026,429	$13,226,900
Profits	225,578	222,244	253,998
Dividends, Preferred	62,214	60,720	59,040
Common	125,000	131,250	162,500
Current Ratio	1.80–1	1.37–1	1.41–1
Net Worth—Debt	.73–1	.33–1	.37–1
Collection Period	196 days	213 days	182 days
Purchases—Net Worth	4.00–1	6.45–1	6.60–1
Profit on Purchases	2.82 %	1.70 %	1.92 %
Profit on Net Worth	11.30 %	11.01 %	12.68 %

Mr. Jeffries succeeded in obtaining the following information about the Madden Finance Company in the course of the next few days:[1]

1. From the Chicago correspondent of the Citizens National Bank, which was also one of the depositories of the Madden Finance Company:

[1] For a suggested procedure in checking on offerings of commercial paper, see Kniffin, W. H., Jr., *Commercial Paper, Acceptances and the Analysis of Credit Statements*, second edition, pp. 40–48.

We have had this account since 1927, and at the present time extend a line of $500,000 on their unsecured note. The subject company makes fairly consistent use of our facilities, having been indebted to us for the full amount of their line for the greater part of last year and for six weeks this spring. At the present time they are owing us $425,000. They were out of our debt entirely from October 16 to November 24, 1929, and have at all times favored us with balances commensurate with their borrowings.

The company is generally recognized as being one of the successful finance houses in this city. We believe that their statement of December 31, 1929, made a good showing, and that their business is holding up surprisingly well this year in view of the general dullness in the automobile trade.

The management is well known to us and is notable for its ability and conservatism. Our own relations with the firm have always been satisfactory, and the information we have received from other sources has been consistently favorable to it. We consider its note a proper banking risk.

2. From a commercial credit agency:

Chicago, Illinois

Madden Finance Company
March 19, 1930

SYNOPSIS

Personnel.—In February, 1927, Mr. Frederick Laird was elected president to succeed Mr. M. J. Madden. The present president was formerly vice president of the Geery Bank of Chicago. The executive staff is experienced and has had a successful operating record.

History.—The company was organized under Illinois laws in 1920. The business consists of financing the sale of automobiles and electric appliances, but no open accounts are purchased.

Financial Information.—The business has been consistently profitable for a long period, although a considerable increase in business in 1928 did not bring a corresponding enlargement of profits. However, the return on net worth has been entirely satisfactory. Indebtedness is less than three times net worth, and is protected by a comfortable margin of cash and receivables. Bad debt losses have been low.

Bank Comment.—Fifteen depositories grant aggregate lines of $5,000,000 on straight note. Aggregate bank credit is somewhat below peak borrowing. Bank comment is favorable and satisfactory balances are carried, although borrowings have been continuous in some cases.

Classification.—Note is regarded as a satisfactory purchase.

ANALYSIS

Statements are audited by R. L. Clare, C.P.A. In connection with the December 31, 1929, figures there were no contingent liabilities. Charged off for bad debts, $52,274. Delinquent installments on December 31, 1929, 60 days, $72,229.

This organization is meeting with success in its operations, but its profits for the last three years have not been as good as in the period before that. The earnings record as a whole has been very satisfactory. In the three years from 1924 to 1926 there was a high margin of profit ranging from 15% to 20% on invested capital. In 1927, 1928, and 1929, the business continued profitable with a return on net worth amounting to 11.3%, 11.0%, and 12.7%, respectively. Dividend payments have absorbed most of the profits.

The principal security for debt, of course, is the cash and receivables. Receivables have been kept in satisfactory shape. Delinquent installments over 60 days past due on December 31, 1929, amounted to .546% of outstandings. An example of the usual composition of receivables is shown in the following segregation as of December 31, 1929:

	Amount Outstanding	Reserves
Notes Arising from Sales of Appliances	$1,842,202	$194,804
Notes of Other Finance Companies Discounted	3,475,009	....
Motor Lien Notes, Retail	1,188,112	11,874
Wholesale	43,496	....
Serial First-mortgage Real Estate Notes	95,954	....
Tax Bills—Secured by Liens on Real Estate	168,704	1,087
Miscellaneous Notes	6,305	....
Totals	$6,819,782	$207,765
Total Receivables, Net of Reserves	6,612,017	....

The ratio of losses to volume has not been at all excessive. Ratios of bad debts to volume have been as follows: 1924—.37%; 1925—.48%; 1926—.65%; 1927—.64%; 1928—.41%; 1929—.39%.

GENERAL INFORMATION

This company engages in a rediscount business and also itself finances the sale of automobiles and electric appliances, but does not purchase open accounts receivable.

Method of Operation.—In financing automobiles the company purchases paper made in the sale of low- and medium-priced pleasure cars, advancing $66\frac{2}{3}$% of the retail value or 85% of the wholesale value thereof. The principal makes of cars financed are Ford, Chevrolet, Marmon, Graham Paige, and Buick. The company does not handle truck or taxicab paper or finance the sale of used cars, and it does very little floor-plan financing. Automobile financing is confined to Chicago and its immediate vicinity. All paper is protected by the assets of the makers, a lien on the vehicles, and the endorsement of the dealers originating the sale, who agree to take back repossessed cars. All obligations mature in 15 months at the most.

In financing electrical appliances, the company advances 75% to 90% of the face value of the merchandise, requiring the balance to be paid in 12 to 15 months. All arrangements are made with the manufacturer, and the company does no financing for small dealers except with factory guarantee. These notes are protected by the resources of the original obligor whose credit is personally investigated, a lien on the merchandise, endorsement of the dealer, and the guarantee of the manufacturer.

The company has reduced the amount of serial real estate notes which it holds from $731,250 in March, 1928, to $95,954 as of December 31, 1929.

BANK COMMENT

The company maintains accounts with 15 depositories. These extend individual lines of credit ranging from $50,000 up to $600,000. Notes payable during 1929 have exceeded aggregate bank lines, the excess being obtained by open-market borrowing. Technically, of course, it is desirable to have open bank lines equivalent to the amount of commercial paper outstanding. The company is an active user of bank credit, but makes periodic clean-ups with many of its banks. With others, borrowings have been somewhat continuous, but proportionate balances are carried. Depositories continue to speak in favorable terms of the concern and its management.

3. From the commercial-paper broker whose salesman had offered the paper to the Citizens National Bank:

We have received no interim information on the Madden Finance Company since its statement of December 31, 1929, but we understand that they are doing a very satisfactory and profitable business at this time.

At present they owe through us $1,236,900. During 1930 to date their high point was in March, when they owed us $1,308,750, and the low point was in February, when they owed us $1,135,000.

We still hold the company and its management in the highest regard.

After reading the foregoing comments and analyzing the financial statements of the Madden Finance Company, Mr. Jeffries concluded that the paper would make a desirable short-term investment for the Citizens National Bank. However, since he had never purchased installment finance company paper in the past, Mr. Jeffries thought it wise to discuss the matter with the president of the bank. In stating his attitude toward the paper, the president said he believed that if the Chicago correspondent of the Citizens National Bank saw fit to lend the concern $500,000, there could be little doubt that its four-months' note would be met at maturity. At the same time he raised the following objections to the purchase:

(1) By the very nature of a finance company's business, it was handling risks which a commercial bank would not assume. Although diversification of these risks reduced the likelihood of loss and, specifically, although the bad debts of the Madden Finance Company were small in comparison to its total volume of business, the security behind this paper was not unimpeachable, particularly in view of the adverse business conditions prevailing in 1930.

(2) Finance company paper was not rediscountable at the Federal reserve banks, and consequently was not liquid. Although the Citizens National Bank probably would not need the funds which it considered placing in this paper until the demands of its customers for accommodation showed their normal seasonal expansion around September 1, the additional ¾ of 1% yield obtainable on the Madden Finance Company's paper scarcely compensated for its lack of liquidity.

(3) It was practically impossible to make an intelligent analysis of a finance company's statement because of the difficulty of evaluating the receivables. Consequently, if finance company paper were wanted, it might be preferable to purchase the paper of a concern which was larger and better known than was the Madden Finance Company, and one to which credit agencies gave a higher rating.

(4) While the financing operations of the Madden Finance Company appeared to be on a sound basis, there was no assurance that the smaller concerns whose paper it discounted were reputable or were accepting only the better risks. A large percentage of receivables consisted of this class of obligations, and there was an apparent lack of any reserves against them.

(5) The company did not have sufficient bank credit available to cover the outstanding amount of its open-market obligations.

Wherein are finance companies different from banks?

Should the unsecured notes of an installment finance company, as sold to banks, be classified as "commercial paper"?

Is finance company paper a desirable outlet for the surplus funds of either city or country banks?

Should banks follow the method of selecting "outside paper" on the basis merely of knowing that other banks have bought it?

What conclusions are suggested by a study of the balance sheets of the Madden Finance Company?

WESTERN CREDIT COMPANY

EXTENSION OF CREDIT TO AN INSTALLMENT FINANCE COMPANY

On December 5, 1930, Mr. Moore, credit manager of the Stanton Bank & Trust Company of Chicago, received an inquiry from Mr. Jeffries, cashier of the Citizens National Bank, a small Iowa correspondent of the former bank. Mr. Jeffries' letter and Mr. Moore's reply are shown below.

DEAR MR. MOORE:

You may remember that we sent you an inquiry last April regarding the open market offerings of the Madden Finance Company of Chicago. When we learned that the Stanton Bank & Trust Company had granted this concern a credit line of $500,000 and that you considered its note a proper risk, we invested some of our surplus funds in this paper. This was our first purchase of installment finance company paper, and our experience with it was entirely satisfactory.

We have recently bought, on a 10-day option, $15,000 of the collateral trust notes of the Western Credit Company of Toledo, Ohio, which will pay us 4% as compared with current yields of 3% to 3¼% on good commercial paper. It appears to us that this paper is a somewhat better risk than was that of the Madden Finance Company, because it is rated "desirable" whereas the latter was "satisfactory," and because it is secured by collateral up to 120% of the amount of outstandings whereas the Madden paper was unsecured.

We would like to have your opinion of this new name, and any information that you may be willing to send us will be greatly appreciated.

Very truly yours,

W. S. JEFFRIES, Cashier

DEAR MR. JEFFRIES:

I have your letter of the 4th, relative to the notes of the Western Credit Company.

You will be interested to learn that we refused this company's application for a $300,000 line about six weeks ago, although that fact should not discourage you from making a commitment in its open-market paper. Our refusal to grant this line was due entirely to the disproportionately large amount of credit which we are extending, in the aggregate, to finance companies, and to the fact that we prefer not to take on the smaller concerns in this field even though we may obtain a good rate of interest from them. I believe that the Western

EXHIBIT 1

Financial Statements of the Western Credit Company, as of December 31, 1927, September 30, 1928 and 1929, December 31, 1929, and June 30, 1930

	December 31, 1927*	September 30, 1928†	September 30, 1929	December 31, 1929	June 30, 1930
Assets					
Cash	$ 565,265	$2,369,525	$ 1,011,300	$ 1,109,060	$1,205,360
Cash with Trustee	53,140				
Notes Receivable with Trustee	2,310,680	3,301,544	4,029,208		
Notes Receivable on Hand	48,799			6,396,809	6,000,025
Installment Liens and Accounts Receivable	....	816,271	2,620,077		
Current Assets	$2,977,884	$6,487,340	$ 7,660,585	$ 7,505,869	$7,205,385
Furniture and Fixtures	10,566	12,370	24,343	27,479	36,045
Repossessed Cars	511	4,221	7,712	20,037	16,884
Due from Officers	15,919	....	39,864	....	....
Deferred Assets	29,907	62,623	105,231	83,862	89,436
Miscellaneous Assets	13,724	35,324	57,804	7,269	6,331
Investments	125,000	....	12,750	54,133	62,882
Advances to Subsidiary	62,656	....	....	....	....
Total Assets	$3,236,167	$6,601,878	$ 7,908,289	$ 7,698,649	$7,416,963
Liabilities					
Notes Payable	$ 78,439	$ 135,822	....	....	....
Collateral Trust Notes	1,903,125	3,283,125	$ 4,190,625	$ 3,850,000	$3,734,375
Accounts Payable	8,779	40,864	96,010	37,200	62,450
Reserve for Taxes	13,750	22,000	42,050	35,000	26,060
Reserve for Dividends	39,550	5,230	50,000	50,000	48,970
Dealers' Loss and Other Reserves	9,503	179,540	416,449	573,614	429,531
Miscellaneous Current Liabilities	....	....	5,369	....	....
Current Liabilities	$2,053,146	$3,666,581	$ 4,800,503	$ 4,545,814	$4,301,386
Unearned Income	116,250	225,000	300,000	375,000	338,125
Capital Stock	1,000,000	2,500,000	2,500,000	2,500,000	2,500,000
Surplus	66,771	210,297	307,786	277,835	277,452
Total Liabilities	$3,236,167	$6,601,878	$ 7,908,289	$ 7,698,649	$7,416,963
Gross Receivables Purchased	$5,617,966	....	$13,780,426	$17,777,392‡	$6,808,013§
Net Profits	86,286	....	261,325	280,999‡	100,232§
Dividends	70,362	....	150,000	200,000‡	100,000§

* Statement of the Western Credit Company of Ohio, predecessor company.

† Giving effect to new financing consisting of the issuance and sale of 100,000 shares of no par, cumulative Class A stock and 150,000 shares of no par common stock.

‡ Fifteen months.

§ Six months.

Credit Company offered us 5%. In this connection, I should explain that we have made an exception to our policy in the case of the Madden Finance Company, because it is an old customer of ours and there is a fairly close tie-up between its management and some of our officers.

When we investigated the Western Credit Company last October, we received excellent checkings from a representative list of banks in Toledo and Cleveland. We felt also that its statements made a good showing and, as far as I know, its note is an acceptable risk.

Very truly yours,

F. MOORE, Credit Manager

The report of a commercial credit agency on the Western Credit Company is shown in the following paragraphs, and the financial statements of the concern are presented in Exhibit 1. Exhibit 2 gives the important ratios derived from the statements of the Western Credit Company compared with typical ratios for automobile finance companies.

SYNOPSIS

Personnel.—In September, 1928, Mr. Ralph Wadhams, former president of the Wadhams Auto Finance Company, became president of this concern. The other officers are experienced in the field of installment financing.

History.—The company was incorporated under Delaware laws in September, 1928, as a consolidation of the Western Credit Company of Ohio and the Wadhams Auto Finance Company. It is engaged in financing the sale of automobiles and income-producing machinery. It also finances real estate improvements and purchases open accounts receivable.

Financial Information.—This organization has been a money maker since its inception in 1928, and the two predecessor companies also enjoyed favorable earnings records. Rapid progress in the volume of business transacted has not been at the expense of financial strength. On June 30, 1930, indebtedness amounted to only 1.5 times net worth, and losses from bad debts have been moderate.

Classification.—Note is regarded as a desirable purchase.

ANALYSIS

Statements are audited by Todd & Company. As of June 30, 1930, the company had no contingent liabilities. Bad debts charged off in the six months preceding this statement amounted to $20,773. Delinquent installments on June 30, 1930, were as follows:

Motor Lien Notes over 60 Days Past Due	$ 3,908
Equipment Notes 30–60 Days Past Due*	35,893
Property Improvement Notes over 60 Days Past Due	2,858
Open Accounts and Miscellaneous Receivables 30–60 Days Past Due*	96,381
Total	$139,040

* Equipment notes and open accounts which become over 60 days past due are taken up by the manufacturing companies for which the Western Credit Company does these types of financing.

The earnings record of this company, including therein that of its predecessors, has been excellent. For the 12 months ending September 30, 1929, net profits amounted to 1.89% of gross receivables purchased, and 9.30% of net worth. For the first half of 1930 the respective percentages were 1.47 and 7.21 (on an annual basis). The company pursues a liberal dividend policy.

EXHIBIT 2

Comparative Ratios for the Western Credit Company and Other Automobile Finance Companies Using the Open Market

	1927	1928	1929†	1930
Current Ratio				
Western Credit Company	1.45–1	1.76–1	1.59–1	1.67–1
Other Finance Companies*	1.81–1	1.42–1	......	......
Profit on Purchases				
Western Credit Company	1.53 %	......	1.89 %	1.47 %
Other Finance Companies*	1.31 %	1.93 %	......	......
Profit on Net Worth				
Western Credit Company	8.08 %	....	9.30 %	......
Other Finance Companies*	13.43 %	12.70 %	......	......
Net Worth—Debt				
Western Credit Company	.51–1	.73–1	.58–1	.64–1
Other Finance Companies*	.27–1	.35–1	......	......
Purchases—Net Worth				
Western Credit Company	5.26–1	....	4.90–1	......
Other Finance Companies*	11.34–1	7.71–1	......	......

* Source: National Credit Office, *Important Ratios in Prominent Industries Using the Open Market.*

† The September 30, 1929, statement of the Western Credit Company has been used. In other years statement dates for this company are as in Exhibit 1.

Collateral trust notes outstanding on June 30, 1930, were more than covered by cash and motor lien notes alone. Other installment obligations and accounts receivable provided additional liquid capital and gave creditors unusually good protection.

As of June 30, 1930, receivables were segregated as follows:

Motor Lien Notes (Wholesale and Retail)	$2,757,940
Equipment Notes	1,593,110
Property Improvement Notes	185,841
Open Accounts and Miscellaneous Receivables	1,463,134
Total	$6,000,025

The above figures are net of reserves.

The ratio of losses charged off to gross receivables purchased was .30% for the 12 months ended September 30, 1929, and .31% for the 6 months ended June 30, 1930. Losses of the predecessor companies, although somewhat above these figures, were moderate.

GENERAL INFORMATION

One-half of the volume of business of the predecessor companies was automobile financing. The new company expects to concentrate more on open accounts and notes arising from the sale of income-producing machinery and equipment. This trend in its business is already in evidence.

Method of Operation.—In financing automobiles the company purchases its paper principally from the sale of the following makes of pleasure cars: Hudson, Essex, Hupmobile, Durant, Nash, and Reo. Three-fourths of its total retail automobile financing is on new cars, the maximum advance being 66⅔% of the selling price, and one-fourth is on used cars, the company advancing no more than 60%. Notes in both classes of retail financing are payable in monthly installments, with a maximum maturity of 12 months. The company retains a lien through conditional sales contracts on vehicles financed, but none of the notes purchased bear dealer endorsement.

Advances to dealers under the company's wholesale plan are made up to 90% of the wholesale price of cars. A lien on these cars is retained by the company through the use of chattel mortgages, the company carrying insurance on them against fire and theft, and frequently against collision. Manufacturers' guarantees are obtained where possible, but are not customary.

On income-producing machinery and equipment, advances are made up to 90% of the retail price, with payments running from 2 to 18 months. All notes are guaranteed by the manufacturers whose products are financed.

The company purchases the open accounts of manufacturers making staple merchandise. The manufacturer from whom the accounts are purchased must submit to monthly examinations of his books and must have Dun's and Bradstreet's ratings which would be acceptable to insurance companies. No insurance, however, is carried on open accounts. The company advances 75% of the face value of receivables. Any open account which becomes more than 60 days past due must be replaced, and the company claims never to have suffered any loss on purchases of this kind.

Borrowing on the open market is done on collateral trust notes secured by the deposit of receivables with the Tappan Trust Company of Chicago as trustee. All kinds of paper are eligible under the trust agreement, the trustee maintaining collateral amounting at all times to 120% of the amount of notes outstanding. Any collateral which becomes 30 days past due must be replaced, and collections are deposited with the trustee daily to take the place of collateral which has been paid.

BANK COMMENT

The company has accounts with 19 banks. Aggregate open lines of $7,000,000 represent 163% of the largest amount of current indebtedness, exclusive of reserves, which has been recorded on any statement date. This conservative policy is in line with reports that the company is not a continuous borrower at any of its banks and that it keeps satisfactory balances.

Does the evidence show that the Western Credit Company was entitled to a $300,000 bank credit line in October, 1930?[1]

From the point of view of the Stanton Bank & Trust Company was the refusal of this accommodation and the simultaneous continuance of the $500,000 line to the Madden Finance Company[2] sound?

From the point of view of the Citizens National Bank, was the open-market paper of the Western Credit Company a better investment for surplus funds than that of the Madden Finance Company?

How much additional security is provided solely by the collateral trust feature of the Western Credit Company notes as compared with the plain or unsecured notes of the Madden Finance Company?

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[1] "The note of a finance or credit company, which is drawn either directly or indirectly to finance some industrial or commercial concern in the transaction of its business, is not eligible for rediscount, even though it may be secured by paper which is itself eligible for rediscount." Ruling of Federal Reserve Board, XIII, C, 324, *Digest of Rulings of the Federal Reserve Board* (1914–1927, inclusive), p. 38. This ruling has been superseded by Regulation A of the Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, October, 1937.

There has been considerable controversy as to whether finance company paper should be eligible for rediscount. In this connection, see comment upon annual meeting of National Association of Finance Companies, particularly that upon remarks of M. V. Ayres, *Automotive Industries*, November 30, 1929, pp. 781–783, and 800–803; also opposition voiced by the Economic Policy Commission of the American Bankers Association, *New York Times*, May 19, 1930, p. 38, col. 5.

[2] *Supra.*

10. REAL ESTATE LOANS

MRS. ANNA N. PALMER

FIRST MORTGAGE LOAN ON RESIDENTIAL PROPERTY[1]

In October, 1928, Mrs. Anna N. Palmer applied to the mortgage department[2] of the Compton National Bank of Hartford, Connecticut, for a loan secured by a first mortgage on her suburban home. Mrs. Palmer, who was a widow 60 years of age, had been a depositor at the Compton National Bank for a number of years and was known to the bank to be financially responsible.

The assistant cashier, whom the bank sent to examine and appraise Mrs. Palmer's property, reported that her lot, the dimensions of which were 150 feet by 100 feet, occupied a choice corner location in an upper middle-class residential district which was completely built up for several blocks on all sides. The most recent sale of land in the vicinity had been made late in 1926 when an inside vacant lot two blocks distant had brought 35 cents per square foot. By comparison with this transaction, the appraiser concluded that Mrs. Palmer's land was fairly worth 40 cents per square foot, or $6,000,[3] and that even at a forced sale it would bring $4,000 or more.

[1] References for real estate loan cases: Fisher, E. M., "What Is a Good Mortgage?" *Insured Mortgage Portfolio*, July, 1938, pp. 8–10, 21–22; Babcock, F. M., *The Appraisal of Real Estate;* Benson and North, *Real Estate Principles and Practices*, revised edition; McMichael and Bingham, *City Growth Essentials;* North, Van Buren, and Smith, *Real Estate Financing;* Weimer and Hoyt, *Principles of Urban Real Estate*.

[2] The organization of the mortgage department of the Compton National Bank was fairly typical. At the head of the department was a vice president, responsible for placing whatever funds the bank saw fit to invest in mortgages. Under this vice president was an assistant cashier who was the bank's real estate expert. He was in constant touch with the condition of the real estate market and was also a trained appraiser. He examined all properties on which loans were requested and made a full report on them to the mortgage committee. This committee was composed of the vice president in charge of the mortgage department and two other officers who were familiar with local real estate values. On the basis of the assistant cashier's findings, supplemented by their own investigation when a particularly large or unusual loan was applied for, this committee either approved or rejected each application for a mortgage. In the event that the application was approved, the mortgage committee fixed the amount which it believed the bank should lend, the duration which seemed desirable in the particular case, and any other conditions which had to be accepted by the applicant if the loan was to be granted. The recommendation of the mortgage committee, as in the case of other loans which various departments of the bank proposed to make, was presented to the executive committee for final approval.

[3] This so-called transfer method is widely used in appraising vacant land and land on which nonincome-producing buildings have been erected. See Babcock, F. M., *op. cit.*, pp. 95–97.

The eight-room house which occupied this site was of frame construction with steam heat, electric lights, and hardwood floors throughout. Adjacent to the house was a one-car, frame garage. Although 20 years old, the house was substantially built and had been well kept up, the only objection which the appraiser made to it, from the point of view of resale value, being that it contained but one bath. Mrs. Palmer stated that the house had cost her husband over $20,000 to build, and the appraiser gave his opinion that the reproduction value,[1] at the time the mortgage was applied for, was at least $14,000. He placed the fair market value of the property as a whole at $20,000.[2]

In giving Mrs. Palmer's application final consideration, the mortgage committee of the Compton National Bank took the following points into account: (1) Although the real estate market in the spring and summer of 1928 had not been so active as it was during 1927 and the years immediately prior thereto,[3] and

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[1] The reproduction cost method of appraising nonincome-bearing buildings involves a knowledge of the typical cost per square foot or per cubic foot of structures of similar nature. This unit is multiplied by the number of square feet or cubic feet in the building under consideration, and from the sum so derived there is subtracted an amount which makes allowance for age and state of repair. See Babcock, F. M., *op. cit.*, pp. 98–99.

[2] In arriving at this figure, the assistant cashier of the Compton National Bank made use of the summation process (see Babcock, F. M., *op. cit.*, pp. 102–103), which consists simply of adding together the values of land and building after having arrived at these values by separate computations. It is probably fair to say, however, that most skilled appraisers use a rough form of the comparison process (*ibid.*, pp. 103–104) in valuing residential property. In a majority of instances they do not actually pick out similar sites and similar buildings and base their appraisals on the sales prices of such properties. This procedure is rendered unnecessary by their familiarity with real estate values in the districts in which they work, and any comparison which they do make is to a certain extent unconscious. They are able to tell almost at a glance the approximate figure at which any house and lot would sell, and the allowances which they make from this figure for unusual features possessed by any given property are apt to be much more accurate than would seem possible to the layman.

[3] The following figures, compiled by the National Association of Real Estate Boards, indicate the condition of the market:

PERCENTAGE OF REPORTING NEW ENGLAND CITIES INDICATING THE SAME OR CHANGED CONDITIONS IN MAY, 1928, AS COMPARED WITH MAY, 1927*

Activity of Market		Selling Prices	
More Active	....	Higher	11%
Same	45%	Same	55%
Less Active	55%	Lower	34%

* *Commercial and Financial Chronicle*, June 23, 1928, p. 3833.

(*Footnote continued on next page.*)

although some further decline in activity seemed to be in prospect,[1] demand for, and prices obtainable on, residences of the better class appeared to be holding up reasonably well in Hartford. (2) The premises under consideration would bring $10,000, even at a quick forced sale, not only because of their intrinsic value, but also because of the demand for houses in that particular vicinity. There was nothing about the house which would render it unsuitable for occupancy by an average well-to-do family and which would thereby restrict the market for it if resale should prove necessary. (3) The house was occupied by its owner, who was a woman of some means and a valued customer of the bank; consequently, there would be no doubt regarding the payment of interest, and there might be some danger of losing Mrs. Palmer's goodwill if the loan were not granted.

The Compton National Bank offered Mrs. Palmer $9,000 on a first mortgage covering the entire property, the mortgage to run for one year, with the privilege of prepayment, and to bear interest at 6%.[2] This offer was accepted, and, at the expiration of the

INDEX OF REAL ESTATE MARKET ACTIVITY
(Based on activity in each month of 1926 as 100*)

	January	February	March	April	May	June	July	August	September	October	November	December
1927	91.3	90.5	91.7	90.6	91.2	87.8	94.1	96.1	91.2	94.7	96.9	95.7
1928	89.6	92 7	85.2	82.6	90.2	84.2	84.3	91.3	83.8	....	....	....

* *Commercial and Financial Chronicle*, August 3, 1929, p. 710.

[1] "We are now on the tail-end of the sky-rocketing in building . . . There will be considerable property thrown on the market over the next year or two . . . There will be excellent opportunities to buy homes at lower prices." McGill Commodity Service, Incorporated, June 19, 1928. *Commercial and Financial Chronicle*, June 23, 1928, p. 3833.

[2] "Any national banking association may make loans secured by first lien upon improved real estate, including improved farm land, situated within its Federal reserve district or within a radius of 100 miles of the place in which such bank is located, irrespective of district lines. A loan secured by real estate within the meaning of this section shall be in the form of an obligation or obligations secured by mortgage, trust deed, or other such instrument upon real estate when the entire amount of such obligation or obligations is made or is sold to such association. The amount of any such loan shall not exceed 50 per centum of the actual value of the real estate offered for security, but no such loan upon such security shall be made for a longer term than five years. Any such bank may make such loans in an aggregate sum including in such aggregate any such loans on which it is liable as indorser or guarantor or otherwise equal to 25 per centum of the amount of the capital stock of such associa-

year, the Compton National Bank, still considering the loan to be a good one, allowed it to run on without drawing renewal papers. After the mortgage was past due, Mrs. Palmer did not offer to repay the principal but met her quarterly interest payments promptly up to and including September 1, 1930.

Are real estate mortgages of this type a desirable channel for the investment of the funds of a commercial bank?

Is it easier to collect a real estate loan from regular customers than from other persons?

Should the Compton National Bank have made this particular loan to Mrs. Palmer?

Comment on the policies of deliberately holding a past-due loan, and not requiring some reduction of principal at regular intervals.

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tion actually paid in and unimpaired and 25 per centum of its unimpaired surplus fund, or to one-half of its savings deposits, at the election of the association, subject to the general limitation contained in section 5200 of the Revised Statutes of the United States." See: *National Bank Act, as amended . . . July 1, 1933*, §205, or *Federal Reserve Act, as amended . . . July 1, 1933*, Sec. 24.

Prior to the passage of the McFadden Act on February 25, 1927, the Federal Reserve Act, Section 24, provided that a national bank, not located in a central reserve city, could make loans secured by improved and unencumbered city real estate within a 100-mile radius for one year. This provision did not prevent a bank from renewing such loans indefinitely. See Ruling of Federal Reserve Board, XXIV-400, *Digest of Rulings of the Federal Reserve Board* (1914–1927, inclusive), p. 109. As a matter of fact, they were often allowed to run on after the expiration date, payable on demand. The chief purpose of the one-year clause was to lend a measure of liquidity to mortgage loans and to permit periodic reappraisals and changes where a bank felt these to be desirable. It is interesting to note that loans by national banks on real estate increased from $725,452,000 on June 30, 1926, to $1,473,001,000 on June 30, 1930. Between the same dates, loans on urban property increased from $473,369,000 to $1,176,031,000 (see *Annual Report of the Comptroller of the Currency*, 1927, p. 29, and *ibid.*, 1930, p. 43).

The National Housing Act, approved June 27, 1934, provided that real estate loans insured under the act were not subject to the restrictions in Section 24 of the Federal Reserve Act which regulated the amount of the loan relative to the value of the property and set a limit on the terms of such a loan. See case of Frye National Bank, *infra*.

NORFOLK COURT APARTMENTS

FIRST MORTGAGE LOAN ON AN APARTMENT BUILDING

In September, 1924, the Howard National Bank, located in a Massachusetts industrial city of 125,000 inhabitants, was offered a first mortgage on a newly constructed apartment house in that city. Mr. Gerald Eaton, who had put up the building with his own funds believing that it would prove to be a desirable investment, was a large depositor in the Howard National Bank. Since Mr. Eaton was willing to retain a substantial equity in the property, he had brought the mortgage to the Howard National Bank as a matter of convenience to himself and a favor to the bank, instead of applying to a savings bank or other institution where he probably could have secured a larger amount of mortgage money.[1]

Mr. Eaton told Mr. John Hazen, the vice president in charge of mortgages at the Howard National Bank, that for some years he had owned a piece of real estate in a suburban business center about a mile from the downtown section of the city. This plot, with a frontage of 72 feet on one of the main arteries out of the city, and a depth of 115 feet, had been occupied by a one-story, frame store building which returned an annual net rental of

[1] Massachusetts savings banks may lend up to 60% of the value of improved real estate located in the commonwealth. See Statutes Relating to Savings Banks—General Laws, Ch. 168, Sec. 54.

Massachusetts trust companies are not specifically restricted as to the percentage of the value of property which they may lend on first mortgages. The state bank commissioner may, however, "make such order . . . as he deems advisable" in cases where it appears that a trust company or co-operative bank has made, or is about to make, an excessive loan on real estate. See: Statutes Relating to Trust Companies—General Laws, Ch. 172, Secs. 33, 34, 51, and 61; Statutes Relating to Banks and Banking—General Laws, Ch. 167, Sec. 10.

Massachusetts co-operative banks are restricted: "When a loan is made the equity of the borrower shall be at least 20% above all encumbrances when the security is improved real estate." See Statutes Relating to Co-operative Banks—General Laws, Ch. 170, Secs. 23, 25, and 26. Co-operative banks, like trust companies, may have their mortgage loans reviewed by the state bank commissioner when he considers these loans to be excessive.

Massachusetts credit unions may lend up to 80% of the value of any individual piece of real estate mortgaged to them, but the law provides that loans for more than 60% must be amortized "at the rate of at least 6% per annum until such loan is reduced to said 60%." See Statutes Relating to Credit Unions—General Laws, Ch. 171, Sec. 24.

Institutions other than banks (namely, building and loan associations, etc.) which accept deposits in the State of Massachusetts may not lend more than 80% of the value of mortgaged property. See Statutes Relating to Deposits with Others than Banks—General Laws, Ch. 169, Sec. 12.

$3,700. Mr. Eaton, however, did not consider this a satisfactory income from the property, since he valued the land alone at over $40,000. Consequently, he had erected a five-story, frame and brick veneer apartment house on the site. This building, which was called Norfolk Court, had been finished during the summer of 1924 and had cost $114,000. By September of that year it was completely occupied by tenants holding one-year leases. The schedule of income to be derived from the 45 apartments in the building was submitted to the Howard National Bank and is reproduced in Exhibit 1.

EXHIBIT 1

Income to be Derived from Norfolk Court Apartments

10 Apartments—3 Rooms—Bath and Kitchen	$60.00 per Month..........	$ 600
10 Apartments—2 Rooms—Bath and Kitchon	55.00 per Month..........	550
8 Apartments—1 Room and Alcove—Bath and Kitchen	47.50 per Month..........	380
10 Apartments—1 Room and Alcove—Bath and Kitchen	35.00 per Month..........	350
7 Apartments—1 Room—Bath and Kitchen	35.00 per Month..........	245
Monthly Rental....................................		$2,125
Yearly Rental....................................		$25,500

Mr. Eaton stated that he believed the bank would find the property to be worth more than $150,000, under whatever method of appraisal it used, and asked that he be given a one-year $75,000 mortgage at 5½%.

Because of the size of the proposed loan, Mr. Hazen decided to make a personal inspection of the property. His investigation led him to conclude that the land could be fairly valued at $5 per square foot, or $41,400 for the plot. However, he was inclined to value the building at considerably less than cost because of its cheap construction[1] and the changing nature of the district in which it was situated. The small business center in which Norfolk Court was located had at one time been surrounded by a good middle-class residential section, but during the war and the years immediately following several factories had been built in the vicinity. Since that time the city's least desirable foreign elements had been taking possession of the neighborhood. This fact had not depressed land values, since the demand for store and office space had increased with the increase in the number of people living in the vicinity. At the same time, Mr. Hazen felt there was a

[1] The Norfolk Court building contained 312,000 cubic feet of space, making the cost of construction approximately 36½ cents per cubic foot. This figure is fairly typical of the cost of steam-heated, nonfireproof apartments, but is scarcely more than half that of a modern fireproof building with elevator. See Benson and North, *op. cit.*, p. 170.

strong possibility that an apartment building in that part of town would tend to deteriorate toward the low-rental, tenement class. He believed this was particularly likely to happen since the building itself was of cheap construction and did not hold out inducements, such as elevator service and other modern conveniences, which would appeal to the better class of tenants. Consequently, he did not feel justified in placing a value on the building in excess of $80,000.

The same considerations led Mr. Hazen to discount the evidence as to the value of the property which was furnished by the schedule of rentals (Exhibit 1). It was the bank's custom to appraise income-bearing property on the basis of gross returns when net figures were not available,[1] the value of an apartment building usually being taken at six times its gross receipts. On this basis Norfolk Court would have a valuation of $153,000, or practically the same as Mr. Eaton's combined estimates of the value of the land, $40,000, and the building, $114,000. On the other hand, it appeared that Mr. Eaton's success in filling Norfolk Court at the rentals which he asked was due primarily to the newness of the building and its convenience to the downtown section of the city. Mr. Hazen felt that in the not distant future Mr. Eaton would have to choose between reducing rents and appealing to a lower class of tenants, or suffering a large percentage of vacancies in the building. Consequently, he estimated $20,000 as a fair average gross rental for Norfolk Court, which would make its value $120,000, and concluded that the bank should not lend more than $60,000 on a first mortgage on the property. He also decided that it would be necessary to charge 6% interest because of the element of risk involved in making the loan. In fact, Mr. Hazen felt that the proposed loan would be a questionable one regardless of amount and rate, and that, if it were granted at all, Mr. Eaton should be made to understand that the bank offered no assurance of a renewal at the end of the year.

How does this loan compare, as to safety, with that to Mrs. Anna N. Palmer?[2]

What was Mr. Eaton's plan for acquiring the funds needed to meet his loan at its maturity?

What decision should the Howard National Bank have made with reference to granting this loan?

[1] See Benson and North, *op. cit.*, pp. 170–171.
[2] *Supra.*

JAMES BRINSON

FIRST MORTGAGE LOAN ON STORE BUILDING LEASED BY A SINGLE TENANT

In August, 1929,[1] the Compton National Bank was approached by Mr. James Brinson, who wished to obtain a mortgage on a one-story store building which he was planning to erect. Mr. Brinson, who was well known to the bank as a successful real estate operator, had purchased recently a plot of land 37 by 100 feet adjacent to a large local meat and vegetable market. He believed that this site would be excellent for a national chain grocery store because the number of passers-by was large and many of them, attracted by the adjoining market, could be expected to have the purchase of groceries in mind. Almost immediately after purchase, Mr. Brinson arranged to lease the property to one of the best known national chains which had approved his plans for the construction of a $20,000 brick and stone building on the lot. The terms of the lease, which was to become effective on completion of the building, had been settled upon, as follows: (1) the lease to run for five years with an option to renew at the same rental for an additional five years, and (2) the chain store company to pay an annual net rental of $4,000.[2]

Although the Compton National Bank customarily did not lend on income-bearing property when the income was dependent on continued occupancy by a single tenant, an exception to this rule might be justified in the case under consideration. The bank was confident that Mr. Brinson's signature on the mortgage note constituted excellent ultimate security in the event that the property pledged should prove insufficient. It felt also that there was little risk of default in the collection of the rents because of

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[1] In June, 1929, the National Association of Real Estate Boards' index for the activity of the real estate market in the country as a whole stood at 82.3, on the basis of activity in June, 1926, as 100. *Commercial and Financial Chronicle*, August 3, 1929, p. 710.

[2] Net rental is the term applied in cases where the tenant pays all expenses and carrying charges on the property, the rent derived by the landlord being net to him. These expenses and charges include taxes, water, electricity, fire insurance, etc. See Benson & North, *op. cit.*, p. 132.

the strength and good reputation of the chain store company leasing the premises. However, because of the somewhat unusual circumstances surrounding Mr. Brinson's application, the members of the bank's mortgage committee made a personal investigation of the property in order to determine whether or not to recommend the proposed loan to the executive committee.

Although Mr. Brinson stated that he believed the plot of land, for which he had paid \$24,000, was worth \$30,000, the bank's investigators felt that its fair market value was not more than \$20,000. They based this opinion on comparisons with prices paid for vacant lots in the vicinity, which indicated that \$5.50 a square foot was a liberal price for land in that section of the city. After examining the plans for the building which Mr. Brinson was about to erect, the bank's representatives stated that they were willing to accept \$20,000 as a fair valuation for the completed structure.[1] Consequently, the mortgage committee offered to recommend that the bank take a \$20,000 three-year mortgage at 6% on the property, one-half to be advanced when the mortgage was placed, and the balance on completion of the building.

Mr. Brinson objected strongly to this recommendation. He contended that the bank's appraisers had put too much weight on what he characterized as the resale value of the property. He also pointed out that appraisal in a case of this kind should be based on the capitalization of net income,[2] stating that if this method were used the value of the property would be found to be at least \$50,000.[3] Mr. Brinson did not object to the 6% rate suggested by the bank or to the withholding of half the mortgage money until the building was completed. However, he felt that a five-year mortgage for \$25,000 should be granted.

The members of the committee agreed that Mr. Brinson had secured a very desirable tenant, and there was no doubt that interest charges even on a \$25,000 mortgage were adequately covered by the rental to be received. At the same time, they pointed out that if the tenant company should get into difficulties there would be no assurance of being able to execute another lease at such a favorable rental.

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[1] In this case the cost of construction method was used in valuing the building. This method, without making allowance for depreciation, is applicable only to new structures. See Babcock, F. M., *op. cit.*, pp. 97–98.

[2] The accepted method for valuing income-bearing property. See Babcock, F. M., *op. cit.*, pp. 104–106.

[3] Assuming an 8% capitalization basis, which Mr. Brinson felt to be conservative.

MANUEL TRUST COMPANY

FINANCING OF A SUBDIVISION PROJECT[1]

In the latter part of June, 1921, Mr. J. W. Evans, a Boston real estate dealer, approached the Manuel Trust Company of that city with a request for a $40,000 loan, the proceeds of which he intended to apply toward the purchase and development of a piece of residential property in a near-by suburban district. Mr. Evans stated that he wished the bank to make this loan on his personal note for one year, and that he was not prepared to offer a mortgage on the property in question as security. He outlined the proposal which he had in mind, as follows.

A 22-acre plot of cleared land in the suburb of Stanwood had been offered to Mr. Evans for $50,000. The owner had agreed to accept a down payment of $12,500, and to take a purchase money mortgage at 6½% for the balance. This mortgage was to include a release clause providing for the release of lots as sold, on the payment of $750 for each lot so released until the remaining $37,500 was discharged.

After the land had been secured, it was Mr. Evans' plan to level and grade it, and to put in sewers, surfaced streets, and sidewalks. The city of Stanwood would install water mains. The gas mains and electric wiring would be provided by the local public service company on the order of individual lot owners.

On the basis of 84 lots, each 100 feet by 75 feet, divided equally into 6 blocks, 14 lots to the block, Mr. Evans estimated the expenses as shown in Exhibit 1.

EXHIBIT 1

Developmental Expenses for the Proposed Subdivision

Surveying, at $12 per Lot	$ 1,008
Levelling and Street Grading, at $1,000 per Acre	22,000
Sewers, at $150 per Lot	12,600
Sidewalks and Surfaced Streets, at $250 per Lot	21,000
Total	$56,608

[1] See North, Van Buren and Smith, *op. cit.*, Ch. XVII.

The next step would be the erection of a few houses, which would serve to attract prospective purchasers and which could themselves be sold at a fair profit. For this part of the work, Mr. Evans had secured the services of a contractor who was willing to erect the houses on joint account.

Mr. Evans presented the Manuel Trust Company with ample evidence of the rapid growth of Stanwood, and stated that the demand for building lots in the vicinity was so strong that he was convinced he could sell the entire tract in a few months after the completion of the proposed improvements. He expected to be able to realize an average price of $2,500 each from his 84 lots. He believed that one-third of the lots would be paid for outright and that he could obtain an average down payment of $750 on the others.

Finally, the bank was furnished with a budget of estimated income and expenses connected with the development, as shown in Exhibit 2.

EXHIBIT 2

Estimated Income and Expense Schedule for the Proposed Subdivision

Gross Sales, 84 Lots at $2,500	$210,000.00	
Less 10% Cash Discount on 28 Lots	7,000.00	
Net Sales		$203,000.00
Less Cost of Lots—Land	$ 50,000.00	
Improvements	56,608.00	106,608.00
Gross Profit		$ 96,392.00
Other Deductions		
Salesmen's Commissions, 10% of Gross Sales	$ 21,000.00	
Administrative and Advertising Expense, 15% of Gross Sales	31,500.00	
Interest on Loan and Mortgage for One Year	4,837.50	
Taxes, Title Insurance, and Miscellaneous	5,000.00	62,337.50
Net Profit		$ 34,054.50

The Manuel Trust Company sent a member of its real estate loan department to appraise the land which Mr. Evans contemplated buying, with instructions to furnish a complete report on the project. This appraiser considered the tract in question to be worth fully $50,000. In fact, he felt that Mr. Evans might be making a mistake in not doing more landscaping on this plot and fixing an even higher price for the lots. Nevertheless, he was satisfied that Mr. Evans would have little trouble in disposing of all the lots in a year's time, if the demand for real estate in Stanwood remained as strong during the ensuing year as it was at the

time. Regarding the expense budget submitted by Mr. Evans, the investigator stated that the administrative and advertising appropriation appeared rather small. Furthermore, he believed it quite improbable that the lots bought on time would be paid for completely by June, 1922, or that the payment of taxes and mortgage interest could be entirely avoided after that time. Aside from these two items, he felt the estimates to be reasonably correct.

The bank believed that no one could question Mr. Evans' integrity or his ability as a real estate operator. He had been a depositor at the Manuel Trust Company for some years and had maintained an average balance of approximately $15,000. The financial statement which he had furnished when applying for the loan showed a satisfactory condition.

The Manuel Trust Company knew that any subdivision project was subject to a large degree of uncertainty and that Mr. Evans would object to paying more than 6%.

Assuming that Mr. Evans is able to complete his plan, with income and expenses as budgeted in Exhibits 1 and 2, prepare a monthly cumulative schedule of his probable net cash outlay.

Consider the various contingencies that may alter his plan, estimate their probable effects, and prepare a revised monthly cumulative schedule of his probable net cash outlay.

On the basis of the two foregoing calculations and any other outside considerations that may affect the result, determine the adequacy of the bank loan requested to finance the plan, and the time zone within which the bank may reasonably expect to have the loan repaid.

Is this a commercial or real estate loan?

Is there any essential difference between this loan to a customer marketing vacant lots, and a loan to a borrower who is manufacturing an article to be marketed some time in the future?

Should the Manuel Trust Company have granted Mr. Evans' request and, if so, upon what terms?

FRYE NATIONAL BANK

MORTGAGE LOANS UNDER THE NATIONAL HOUSING ACT[1]

In December, 1934, the directors of the Frye National Bank, located in a section of Ithaca, New York, that had grown up around the state university, were considering a suggestion that the bank resume lending against real estate. If the policy were approved as proposed, the bank would apply to the Federal Housing Administration[2] for approval as a mortgagee, and the bank's commercial department would invest in first mortgages[3] insured as to ultimate repayment under the provisions of the National Housing Act.

In the past, the bank had confined its mortgage holdings almost entirely to the savings department. Although the experience with such loans had been satisfactory, the bank had made few new mortgage loans for over two years despite the many inquiries that had been received during that time from persons connected with the university and from others of equally substantial worth. In December, 1934, very few of the mortgages held by the bank were delinquent, although in some cases the bank had agreed to postponements of reductions of principal.

Because of the bank's location, almost all of its checking business was made up of student and household accounts. The bank therefore experienced typically a greater fluctuation of deposits than a bank which had a larger proportion of accounts from business interests. It was normal for the checking deposits of the bank to decline 20% during a month and to return to their former figure after deposits of pay checks were received at the beginning of the following month. The month-to-month fluctua-

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[1] *48 Stat.* 1246, Ch. 847. The power of national banks to lend on real estate was changed by Sec. 505 of the National Housing Act, authorizing real estate loans for longer periods than five years and in excess of 50% of appraised valuation, and providing for the classification of construction loans as eligible commercial paper under certain conditions. See Federal Housing Administration, *National Housing Act As Amended . . . to June 3, 1939.*

[2] Hereinafter referred to as the F.H.A.

[3] In this case the bank considered the advisability of originating F.H.A. mortgages to be held. As to origination for sale, see case of Taylor Bank, *infra*. Approved banks could purchase insured mortgages originated by others. As to the investment status of such purchases, see: Smith, L. P., "Revamping the Investment Portfolio," *Insured Mortgage Portfolio*, October, 1938, p. 3*ff*.; Stoner, P. M., "Mortgages and the Commercial Bank," *Insured Mortgage Portfolio*, October, 1938, p. 9*ff*., and November, 1938, p. 12*ff*.

tion was small and the bank had not been required to meet sudden large declines in deposits except for a brief period prior to the bank holiday in 1933. The bank had not borrowed or rediscounted for more than ten years and aimed always to maintain such a strong financial position that borrowing would be unnecessary. The directors had felt that the illiquidity of mortgage investments made them inadvisable for the commercial department of any bank, even though there was no doubt of the "goodness" of a loan.

Deposits in the savings department of the bank were much more stable in amount, although they had declined during the depression. The bank had been able to meet the withdrawals from this department chiefly by the use of reductions on the principal of outstanding mortgages, and also by the sale of bonds of the Home Owners' Loan Corporation, obtained in settlement of certain mortgage debts.

Because of the small demand for loans at the end of 1934, the bank at that time held a large amount of high-grade, short-term securities, as shown by its statement of condition, in Exhibit 1. Many of these investments were yielding less than 2%. It

EXHIBIT 1

Statement of Condition of the Frye National Bank, as of November 30, 1934

Resources		Liabilities	
Cash	$1,003,134	Capital	$ 150,000
United States Bonds	517,690	Surplus	210,000
State and Municipal Bonds	111,260	Undivided Profits	268,024
Other Securities Owned	754,010	Checking Accounts	2,559,114
First Mortgages Held*	1,555,457	Savings Accounts	1,620,919
Loans and Discounts	787,638		
Other Resources	78,868		
Total Resources	$4,808,057	Total Liabilities	$4,808,057

* Approximately $432,000 held in commercial department.

was pointed out to the directors that a yield of about 5% could be obtained from the proposed mortgage investments and that the operations of the F.H.A. were calculated to remove many of the objections which formerly could have been raised against mortgage investments in the commercial department.[1] Also, it

[1] The current regulations of the F.H.A. stated maximum interest rates and other charges upon mortgages as classified by the nature of the transaction out of which

was claimed that, if the bank entered the mortgage field before the local savings banks and other lenders, it would obtain its choice of the mortgages offered.

The following features of the new system of mortgage financing were emphasized by the advocates of the proposed policy. First, the insured mortgages would have a satisfactory market. The F.H.A. was proceeding as rapidly as possible with the organization of national mortgage associations, as provided for by Title III of the National Housing Act.[1] These associations, after appraising the property, would buy insured mortgages, without warranty or recourse from approved mortgagees, and would sell mortgages or participation certificates from their own portfolios. Thus a market would be provided both for the purchase of insured mortgages and for their sale by approved mortgagees and others. Also, a more active general market in mortgages than had existed in the past would be furthered by the regulations of the F.H.A. that required a standard form of mortgage, standard provisions for its service, and conservative criteria for appraisals.

Second, it was required that borrowers on insured mortgages make monthly payments covering interest, service charges, taxes, and insurance; also that amortization be completed within 20 years. Such requirements were advantageous to the lender because they provided for a general reduction of the principal of a loan and furnished funds for taxes and insurance in advance. For the borrower, a monthly schedule of payments usually was easier to meet.

Third, the insurance provisions of the National Housing Act protected the principal invested in real estate loans and gave assurance that part, at least, of the interest and other amounts due from a defaulting mortgagor would be recovered. Also, an approved mortgagee would be relieved of the expense and difficulty of managing properties that had to be taken over, since the F.H.A. itself would take charge after the property had been conveyed by foreclosure or otherwise.

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the indebtedness arose. The interest rates so set were 5% or 5½% per annum, and service charges of ½% per annum were permitted for certain of the classes. Insurance premiums were ½% or 1% per annum on the original principal.

[1] In December, 1934, no national mortgage association had been organized in central New York. The act of January 31, 1935, approved after the date of this case, gave authority to the R.F.C. to subscribe for or make loans upon the nonassessable stock of any class of any national mortgage association.

Again, it was contended that the plan of the F.H.A. deserved support as a sound measure looking toward recovery and proper financing in the real estate field. The requirement that loans be "economically sound," and that complete information be furnished by applicants for loans, indicated that the lending of funds would be managed properly, although an expansion of credit might be slow. Also, the provision of the act that first-mortgage loans could be made in amounts up to 80% of appraised valuations made it possible to relieve borrowers from the heavy charges that in the past had confronted them in obtaining a loan on a junior lien such as a second mortgage.[1] Financial institutions participating in the activities of the F.H.A. would be assisting a worthy project, and, at the same time, placing their funds in sound investments yielding a good return.

Finally, the proponents of the change in policy pointed out to the directors that the plan provided a means of assisting the revival of real estate values without artificial stimulation. Those who viewed government spending with alarm should assist sound expansion of private credit wherever possible.

Describe the steps which must be taken by a bank in order to collect the insurance benefits when a mortgage loan becomes delinquent.

What is the significance of state laws on foreclosure procedure and debt moratoria in utilizing the F.H.A. plan of mortgage loan insurance?

What additional security, or value, for bank ownership purposes attaches to a mortgage loan when insured by the F.H.A. plan?

Should the Frye National Bank: (*a*) qualify for the insurance benefits, and (*b*) enlarge its holdings of mortgage loans, even though insured?

Outline a national policy as to bank holdings of mortgage loans, with particular reference to the proportion of aggregate bank portfolios that should be invested therein.

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[1] See: Reep, S. N., *Second Mortgages and Land Contracts in Real Estate Financing*, Chs. V, VIII, IX; Gries and Curran, Department of Commerce BH. 12, *Present Home Financing Methods.*

III

INVESTMENTS

11. BOND PORTFOLIO POLICY

MILLER NATIONAL BANK

MANAGEMENT OF THE BOND PORTFOLIO OF A BANK[1]

The regulation on the purchase of investment securities by national banks, issued in June, 1938, by the Comptroller of the Currency, was developed from a series of regulations, speeches, and discussions on that subject, based upon the Banking Act of 1933, in which restrictions were placed on dealings by banks in investment securities. Since 1933 the management of the bond portfolio of the Miller National Bank, a large commercial bank in Cleveland, Ohio, had been in accord with previously set policies except for such adjustments as were required by new circumstances; no unified review of the situation had been made. Accustomed to the gradual development of regulations following statutory changes, the officers of the Miller National Bank had not thought it wise to set up a permanent policy on the basis of existing restrictions until a sufficient evolution had taken place to afford them some assurance as to the major provisions to be met and as to the direction which further changes might be expected to take. By July, 1938, they felt that this time had come, and therefore that they should reconsider the investment problems of the bank and set for themselves new objectives based on the current and prospective conditions.

The bond portfolio of the Miller National Bank was composed of two separate parts: the secondary reserve and the investment account. The secondary reserve was by far the most important.

[1] References on bank policy in bond operations: Kirshman, J. E., *Principles of Investment*, second edition; Wilkinson, J. H., Jr., *Investment Policies for Commercial Banks;* Ostrolenk and Massie, *How Banks Buy Bonds;* Rodkey, R. G., *The Banking Process*, 1928 edition, pp. 254–256; Dewing, A. S., "The Role of Economic Profits in the Return on Investments," *Harvard Business Review*, July, 1923, pp. 451–463; Stern, R. M., "Government Bond Account Profits Are Fictitious," *American Banker*, March 15, 1939, pp. 1, 7; American Bankers Association, Bank Management Commission, *Statement of Principles and Standards of Investment for Commercial Banks*; Ebersole, J. F., "Protecting Bank Bond Investments," *Harvard Business Review*, Summer, 1940, pp. 410–416.

For cases upon various kinds of obligors and purchases made at different times in the cycle of bond prices, see: Ebersole, J. F., *Bank Management—A Case Book*, first and second editions, Prudential National Bank, Motsworth Trust Company, Keystone National Bank; first edition, Citizens Northern National Bank, Kineo National Bank.

Even before 1930, the president of the bank had believed that it was essential to maintain a strong actual or potential cash position. For this reason the bank always kept about $6,000,000 in cash or on call, and from $4,000,000 to $8,000,000 in United States Government securities. The bank seldom borrowed from the Federal reserve bank, and then only for very short periods. On July 25, 1930, in addition to $8,500,000 of United States Government securities, all of which matured within two years, the secondary reserve account included state, municipal, and corporation bonds, with maturities of not over five years, sufficient to make a total of $17,670,000. Of the whole reserve, 52% matured during 1930, 33% during 1931, 8% during 1932, 3% during 1933, and 4% during 1934.

The size of the secondary reserve account fluctuated inversely with the cash and credit needs of the customers. When the rate on commercial paper exceeded that on short-term bonds, paper was purchased in preference to bonds. No attempt was made to profit by changes in interest rates except on United States Government bonds. The policy of shifting between long-term and short-term bonds in accord with changes in interest rates had been adopted by the vice president in charge of the bond department. Although this vice president managed both the secondary reserve and the investment accounts, the bond department account was not credited with any income from the secondary reserve account. From September to December, 1929, short-term governments had been sold and long-term governments purchased, while in June and July, 1930, the process had been reversed. This policy had been profitable, since the long-term issues purchased at prices ranging from 101 to 104 had been sold at prices ranging from 106 to 108¾.

The remainder of the portfolio, the investment account, was not restricted by liquidity considerations, but was expected to earn as large a profit as possible over the long run. Four methods of securing a return on this fund were utilized by the bank: buying and holding to maturity in order to obtain income from the interest payments, underwriting new issues, trading in special situations where securities seemed undervalued temporarily, and standing ready to buy or sell bonds having a wide margin between bid and asked prices while profiting on the spread.

The bank regularly placed the largest portion of its investment account in bonds to be held until maturity, collecting the interest

as it fell due. Although at first little attention had been paid to bonds of this class after they had been purchased, since 1930 they were subjected to an annual review. Any bonds whose future appeared doubtful and whose unfavorable outlook had not already been fully discounted by the market were sold.

Underwriting by the Miller National Bank had been confined to bidding upon new issues of the highest grade municipals and to subscriptions for new issues of the Federal Government and its subsidiaries. As a retailer only, the bank had participated in the past in syndicates for the sale of corporate issues.

In special situations, whenever investigation indicated undervaluation, a block of listed or unlisted bonds was purchased and held until the market had returned to a more normal valuation. Then the bonds were either sold in the market or transferred to a so-called merchandise account for sale to customers. From time to time the suggestion had come before the directors of the bank to trade more frequently and more extensively, but the bank never adopted such an active policy. Whereas in the issues of the type currently purchased, the securities were selling substantially below a price believed by the bank to reflect their true worth, more active operation in this area would involve trying for smaller profits on a larger number of issues in which less disparity between market price and estimated value could be found.

Where bonds exhibited a wide spread between bid and asked prices, a profit was obtained in another way. By standing ready to buy such securities at slightly over the bid price or to sell them at slightly under the asked price, the bank was able to collect the difference. According to crude estimates, it cost one point to transact such business, so that purchases were not made unless a sale could be expected to follow with a spread of at least one and one-half points above the purchase price. These sales took place entirely on the initiative of the buyer or seller, the bank being passive in the transaction. In performing this function, the bank "sold liquidity to the market" at a price equal to the spread between its bid and asked quotations.

By the Banking Act of 1933, the underwriting of corporate securities and merchandising activities were forbidden to banks. The regulations issued by the Comptroller of the Currency under the authority of the act further restricted the purchase of securities. These regulations and the examination procedure adopted in June, 1938, are presented in Exhibits 1, 2, 3, and 4.

EXHIBIT 1

Statutory Power of National Banks* to Deal in Securities as Conferred by Section 5136, Revised Statutes†

Section 5136.—Upon duly making and filing articles of association and an organization certificate, the association shall become, as from the date of the execution of its organization certificate, a body corporate, and as such, and in the name designated in the organization certificate, it shall have power—

. . . .

Seventh.—To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this title. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, except that this limitation shall not require any association to dispose of any securities lawfully held by it on the date of enactment of the Banking Act of 1935. As used in this section the term "investment securities" shall mean marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States or general obligations of any State or of any political subdivision thereof, or obligations issued under authority of the Federal Farm Loan Act, as amended, or issued by the Federal Home Loan Banks or the Home Owners' Loan Corporation, or obligations which are insured by the Federal Housing Administrator pursuant to section 207 of the National Housing Act, if the debentures to be issued in payment of such insured obligations are guaranteed as to principal and interest by the United States‡: *Provided*, That in carrying on the business commonly known as the safe-deposit business the association shall not invest in the capital stock of a corporation organized under the law of any State to conduct a safe-deposit business in an amount in excess of 15 per centum of the capital stock of the association actually paid in and unimpaired and 15 per centum of its unimpaired surplus.

* "State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph 'Seventh' of Section 5136 of the Revised Statues, as amended."—Paragraph 19 of Section 9 of the Federal Reserve Act, as amended to October 1, 1937, published in the *Digest of Rulings of the Board of Governors of the Federal Reserve System from 1914 to October 1, 1937*, page 350.

† Source: "The Federal Reserve Act as Amended to October 1, 1935," compiled under the direction of the Board of Governors of the Federal Reserve System in the office of its general counsel, pp. 174–175.

‡ [An amendment on February 3, 1938, added the words: " or obligations of national mortgage associations.]"

EXHIBIT 2

Regulation of the Comptroller of the Currency Governing Bank Investment Policy*

By virtue of the authority vested in the Comptroller of the Currency by paragraph Seventh of Section 5136 of the Revised Statutes, the following regulation is promulgated:

Section I

(1) An obligation of indebtedness which may be purchased for its own account by a national bank or State member bank of the Federal Reserve System, in order to come within the classification of "investment securities" within the meaning of paragraph Seventh of said Section 5136, must be a marketable obligation, i.e., it must be salable under ordinary circumstances with reasonable promptness at a fair value; and with respect to the particular security, there must be present one or more of the following characteristics:

(*a*) A public distribution of the securities must have been provided for or made in a manner to protect or insure the marketability of the issue; or,

(*b*) Other existing securities of the obligor must have such a public distribution as to protect or insure the marketability of the issue under consideration; or,

(*c*) In the case of investment securities for which a public distribution as set forth in (*a*) or (*b*) above can not be so provided, or so made, and which are issued by established commercial or industrial businesses or enterprises, that can demonstrate the ability to service such securities, the debt evidenced thereby must mature not later than ten years after the date of issuance of the security and must be of such sound value or so secured as reasonably to assure its payment; and such securities must, by their terms, provide for the amortization of the debt evidenced thereby so that at least 75% of the principal will be extinguished by the maturity date by substantial periodic payments: Provided, That no amortization need be required for the period of the first year after the date of issuance of such securities.

(2) Where the security is issued under a trust agreement, the agreement must provide for a trustee independent of the obligor, and such trustee must be a bank or trust company.

(3) All purchases of investment securities by national and State member banks for their own account must be of securities "in the form of bonds, notes, and/or debentures, commonly known as investment securities"; and every transaction which is in fact such a purchase must, regardless of its form, comply with this regulation.

Section II

(1) Although the bank is permitted to purchase "investment securities" for its own account for purposes of investment under the provisions of R. S. 5136 and this regulation, the bank is not permitted otherwise to participate as a principal in the marketing of securities.

(2) The statutory limitation on the amount of the "investment securities" of any one obligor or maker which may be held by the bank, is to be determined on the basis of the par or face value of the securities, and not on their market value.†

(3) The purchase of "investment securities" in which the investment characteristics are distinctly or predominantly speculative,‡ or the purchase of securities which are in default, either as to principal or interest, is prohibited.

(4) Purchase of an investment security at a price exceeding par is prohibited, unless the bank shall:

(*a*) Provide for the regular amortization of the premium paid so that the premium shall be entirely extinguished at or before the maturity of the security and the security (including premium) shall at no intervening date be carried

EXHIBIT 2. (*Continued*)

at an amount in excess of that at which the obligor may legally redeem such security; or

(*b*) Set up a reserve account to amortize the premium, said account to be credited periodically with an amount not less than the amount required for amortization under (*a*) above.

(5) Purchase of securities convertible into stock at the option of the issuer is prohibited.

(6) Purchase of securities convertible into stock at the option of the holder or with stock purchase warrants attached is prohibited if the price paid for such security is in excess of the investment value of the security itself, considered independently of the stock purchase warrants or conversion feature. If it is apparent that the price paid for an otherwise eligible security fairly reflects the investment value of the security itself and does not include any speculative value based upon the presence of a stock purchase warrant or conversion option the purchase of such a security is not prohibited.

(7) As to purchase of securities under repurchase agreement, subject to the limitations and restrictions set forth in the law and this regulation:

(*a*) It is permissible for the bank to purchase "investment securities" from another under an agreement whereby the bank has an option or a right to require the seller of the securities to repurchase them from the bank at a price stated or at a price subject to determination under the terms of the agreement, but in no case less than the value at the time of repurchase.

(*b*) It is permissible for the bank to purchase "investment securities" from another under an agreement whereby the seller or a third party guarantees the bank against loss on resale of the securities.

(*c*) It is not permissible for the bank to purchase "investment securities" from another under an agreement whereby the seller reserves the right or the option to repurchase said securities itself or through its nominee at a price stated or at a price subject to determination under the terms of the agreement, notwithstanding the fact that the bank may also, under such agreement, have the right or option to compel the seller to repurchase the securities at a price stated or at a price subject to determination under the terms of the agreement.

(8) As to repurchase agreements accompanying sales of securities:

(*a*) It is permissible for the bank selling securities to another to agree that the bank shall have an option or right to repurchase the securities from the buyer at a price stated or at a price subject to determination under the terms of the agreement, but in no case in excess of the market value at the time of repurchase.

(*b*) It is not permissible for the bank selling securities to another to agree that the purchaser shall have the right or the option to require the bank to repurchase said securities at a price stated or at a price subject to determination under the terms of the agreement, notwithstanding the fact that the bank may also, under such agreement, have the right or option to repurchase the securities from the buyer at a price stated or at a price subject to determination under the terms of the agreement.

In view of the fact that some banks may have bought or sold securities under a form of agreement which is prohibited by this regulation, the bank should either terminate or modify same so as to conform to this regulation, where such action may lawfully be taken. Existing agreements of the prohibited type must not be renewed.

Exception

The restrictions and limitations of this regulation do not apply to securities acquired through foreclosure on collateral, or acquired in good faith by way of compromise of a doubtful claim or to avert an apprehended loss in connection

EXHIBIT 2. (*Continued*)

with a debt previously contracted, or to real estate securities acquired pursuant to Section 24 of the Federal Reserve Act, as amended.

This regulation supersedes prior regulations governing the purchase of "investment securities" and is effective from and after July 1, 1938.

Signed and promulgated this 27th day of June, 1938.

Marshall R. Diggs,
Acting Comptroller of the Currency.

* Source: *Federal Reserve Bulletin*, July, 1938, pp. 565–566.

† [In a circular letter issued by the Comptroller of the Currency on January 15, 1935, the position was taken that this limitation was applicable to securities on which a company was indirectly liable as well as those issued by it directly.]

‡ [In a previous regulation issued on February 15, 1936, appearing in the *Federal Reserve Bulletin*, March, 1936, p. 195, a footnote to a similar clause was included, reading as follows: "The terms employed herein may be found in recognized rating manuals, and where there is doubt as to the eligibility of a security for purchase, such eligibility must be supported by not less than two rating manuals." (Why did the Comptroller not include this sentence in issuing the regulation of June 27, 1938?)

For a discussion of the rating of securities, see Kirshman, J. E., *Principles of Investment*, second edition, Ch. XIV.]

EXHIBIT 3

Comptroller's Opinion on the Extent to Which Banks are Limited to the Use of Rating Manuals in the Purchase of Investment Securities*

As is inevitable in the matter of regulations, questions of interpretation arise from time to time. While there has been unanimous approval of the objective toward which these regulations are directed, a committee of the American Bankers Association has suggested that some of their members desire to have clarified certain aspects of the regulations. The provision which has probably been of most interest . . . prohibits the purchase of investment securities in which the investment characteristics are distinctly or predominantly speculative and the footnote states that the terms used in the paragraph may be found in recognized rating manuals, and that where there is doubt as to eligibility, then such eligibility must be supported by not less than two rating manuals.

Inquiry has been made as to whether . . . member banks are . . . confined to the purchase of securities which have a rating classification in one of the four groups according to rating services. The responsibility for proper investment of bank funds, now, as in the past, rests with the directors of the institution, and there has been and is no intention on the part of this office to delegate this responsibility to the rating services, or in any way to intimate that this responsibility may be considered as having been fully performed by the mere ascertaining that a particular security falls within a particular rating classification.

Reference to the rating manuals was made in the regulation in recognition of the fact that many banking institutions, by reason of lack of experienced personnel and access to original sources, are unable personally to investigate the background, history, and prospects of a particular issuer of securities, and consequently must rely to some extent upon such information as has been compiled by various rating services in their large rating manuals. It may also be expected that banking institutions will desire to supplement their own judgment by checking it against the opinion of others, including ratings that have been given by rating services. Such ratings, however, regardless of whether or not they are in the first four groups, are not conclusive on the question of eligibility. It is recognized that some securities, which are entirely eligible from a nonspeculative standpoint at the time they are available for purchase, may have as yet received no rating by the rating services. It is also recognized that a security with a high rating according to the services may, in the circumstances of a particular case, be an undesirable investment, whereas on the other hand, conditions existing at the time of investment may make a security entirely eligible, notwithstanding the fact that it has a comparatively low rating according to the standard rating services. In the latter

EXHIBIT 3. (*Continued*)

type of case, of course, there will be a correspondingly greater burden upon the bank to satisfy the examiners that a particular security is in fact eligible from a nonspeculative standpoint.

+ Excerpts from an address made by the Comptroller of the Currency before the California Bankers Association, at Sacramento, California, on May 22, 1936, *Federal Reserve Bulletin*, June, 1936, pp. 422–423.

EXHIBIT 4

Revision of Procedure in Bank Examinations as Agreed to by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Directors of the Federal Deposit Insurance Corporation, and the Comptroller of the Currency*

The Appraisal of Bonds in Bank Examinations

Neither appreciation nor depreciation in Group I securities will be shown in the report. Neither will be taken into account in figuring net sound capital of the bank.

Group I securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group includes general market obligations in the four highest grades and unrated securities of equivalent value.

The securities in Group II will be valued at the average market price for eighteen months just preceding examination and fifty per cent of the net depreciation will be deducted in computing the net sound capital.

Group II securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes general market obligations in grades below the four highest, and unrated securities of equivalent value.

Present practice will be continued under which net depreciation in the securities in Group III and Group IV are classified as loss.

Group III securities: Securities in default.

Group IV securities: Stocks.

Present practice will be continued under which premiums on securities purchased at a premium must be amortized.

Present practice of listing all securities and showing their book value will be continued.

The Treatment of Securities Profits in Bank Examinations

Until losses have been written off and adequate reserves established, the use of profits from the sale of securities for any purpose other than those, will not be approved.

Present practice will be continued under which estimated losses must be charged off.

Present practice will be continued under which the establishment and maintenance of adequate reserves, including reserves against the securities account, are encouraged.

Present practice will be continued under which speculation in securities is criticized and penalized.

* Source: *Federal Reserve Bulletin*, July, 1938, p. 565.

To help them in deciding upon a proper policy for management of the bank's bond portfolio, the executive committee asked a junior officer to make a study and to set up proposals for a new bond policy. The junior officer decided to investigate the first great collapse of the bond market which he had experienced and to judge how its effect on the bank would have been different if the bond purchases had been made in accordance with the laws, regulations, and practices existing in July, 1938. Data on the "investment account" of the Miller National Bank for June, 1930, as compiled by him, are given in Exhibit 5.

Assuming that the bank decided to purchase on June 30, 1930, the list of bonds actually held in its investment account on tha date, as shown in Exhibit 5, what differences, if any, would hav resulted if the law and regulations as presented in this case then been in effect?

Assuming that the bank held on December 31, 1932, the li bonds in Exhibit 5, and that they had been purchased at the pr shown for June 30, 1930, what would have been the effect of examination procedure of 1938 if it had existed on December 1932?

Are the following profit-making methods legitimate sources of income for commercial banks: (1) shifting from long-term to short-term high-grade bonds and *vice versa;* (2) taking advantage of "promising special situations"; and (3) "selling liquidity"? Are there good reasons why underwriting operations should not be permitted to national banks? Outline the staff requirements for successful operations in the above-mentioned possible sources of profits.

Why should not banks be allowed to buy and sell "second-grade" bonds having a risk factor which varies with business conditions?

Should any bank accept the ratings of one or several of the available financial services, such as that of Moody, Poor, Fitch, or Standard Statistics Company, in purchasing bonds?

In setting policies, should a bank rely upon the permanence of the regulations and policies of the supervising authorities?

EXHIBIT 5

Miller National Bank, Data on Investment Account Portfolio of June 30, 1930

Issue	Number of Bonds Owned	Market Value June 30, 1930	Prices†		Ratings			
			June 30, 1930	December 31, 1932	Moody's‡		Standard Statistics§	
					1930	1932	1930	1932
Rails								
Atchison, Topeka & Santa Fe Gen. 4's, 1995	10	$ 9,575	$ 95¾	$ 95	Aaa	Aaa	A1+	A1+
Atlantic & Danville 1st 4's, 1948	100	62,000	62	14	Baa	Ba	B1+	C1+
Baltimore & Ohio R.R. "A" Ref. 5's, 1995	10	10,350	103½	37½	A	Ba	A	B1+
Canadian Pacific 4% Debenture Stock	12	10,590	88¼	66½	Aaa	Aa	......	A1
Central of Georgia Ry. "C" 5's, 1959	10	10,125	101¼	6⅝	A	Ba	A1	B
Chicago & Alton 1st 3½'s, 1950‖	100	63,625	63⅝	....	B	....	D1+	....
Chicago & Eastern Illinois Ry. Gen. 5's, 1951	200	122,250	61⅛	12	Ba	B	B1+	C
Denver & Rio Grande Western 5's, 1955	10	9,150	91½	13⅞	Ba	B	B	C1
Erie R.R. Ref. & Imp. 5's, 1967	10	9,150	91½	27	Baa	Ba	B1+	B
Florida East Coast 1st 4½'s, 1959	30	25,950	86½	43	A	Baa	A	B1+
Hudson & Manhattan Adj. Income 5's, 1957	250	194,375	77¾	52	Ba	Ba	B1	B1
Illinois Central R.R. 4¾'s, 1966	10	10,025	100¼	35	Aa	Ba	A	B
Iowa Central Ry. 1st 5's, 1938	200	52,000	26**	....¶	B	B	C	D1+
Kansas City Southern Ry. 5's, 1950	10	10,000	100	45⅛	A	Baa	A	B1
Lehigh Valley Gen. Cons. 4's, 2003	12	10,680	89	33	Aaa	Baa	A1+	B1+
Louisville & Nashville R.R. 1st & Ref. "C" 4½'s, 2003	12	11,880	99	60	Aaa	A	A1	B1+
Missouri Pacific R.R. "A" 5's, 1965	10	10,050	100½	23	A	Ba	A1	B1
Missouri Pacific R.R. Gen. 4's, 1975	200	153,500	76¾	10⅞	Baa	Ba	B1+	C1+
New York, New Haven & Hartford R.R. 6's, 1940	10	10,550	105½	74½	A	Baa	B1+	B1+
Penn. R.R. Deb. 4½'s, 1970	15	14,381	95⅞	59½	Aaa	A	A	A

† *Bank and Quotation Record*, July 11, 1930, and January 6, 1933. Sale or bid prices are used.

‡ Moody's *Railroads, Public Utilities, & Industrials*, for 1930 and 1932. Ratings: Aaa, highest grade; Aa, high grade; A, not so highly protected, entirely sound; Baa, warrant more discrimination, good showing however; Ba, some characteristic of uncertainty; B, speculative features, asset value somewhat uncertain, stability poor; Caa, poor statistical standing, bonds in default or standing uncertain.

§ *Standard Bond Book*, 1929, Index & Ratings, No. 34; *Standard Bond Descriptions*, Index & Ratings Section, Issue of January 7, 1933. Ratings: A1+, highest class; A1, high grade; A, sound; B1+, good; B1, fair; B, semispeculative; C1+, speculative; C1, highly speculative; C, uncertain; D1+, weak; D1, very weak; D, doubtful value; *, conditional rating because of insufficient data.

‖ This issue bought in at $80 by B. & O. in September, 1930.

¶ No quotation given for December 31, 1932.

** Asked price—no bid.

†† Poor's 1932 volumes listed Associated Electric Company 4½'s, 1953, as a "Business Man's Investment"; all others were rated "Better Grade Speculative" or lower.

‡‡ Receivership, October 21, 1930.

§§ Part redeemed 10% on June 30, 1930, and 20% on December 31, 1932. In computing the market value on June 30, 1930, the part redeemed was deducted after the computation based upon the quotation, whereas on December 31, 1932, the part redeemed was deducted from the par value before applying the quotation in a computation. The change in method of figuring was made by the New York Stock Exchange on March 12, 1932.

‖‖ Retired October 15, 1930, at $100¾.

EXHIBIT 5. (*Continued*)

Issue	Number of Bonds Owned	Market Value June 30, 1930	Prices† June 30, 1930	Prices† December 31, 1932	Ratings: Moody's‡ 1930	Moody's‡ 1932	Standard Statistics§ 1930	Standard Statistics§ 1932
Rails—(*Continued*)								
Pere Marquette 1st "A" 5's, 1956	10	$ 10,375	$103¾	$ 35	Aa	Ba	A1+	B1
Seaboard Air Line 1st 4's, 1950—Stamped	320	207,600	64⅞**	6	Baa	B	B1+	D1+
Southern Pacific 4's, 1949	12	11,160	93	48½	Aa	Baa	A1+	B1+
Wabash 1st 5's, 1939	15	15,450	103	53½	Aaa	Baa	A1+	C1+
Total		$1,054,791						
Utilities								
American Gas & Electric Co. Deb. 5's, 2028	12	$ 11,760	$ 98	$ 90½	A	Baa	A	A
American Power & Light Deb. 6's, 2016	15	16,087	107¼	56	A	Ba	A	B1+
American Water Works & Electric Co. 5's, 1934	15	15,150	101	93¼	A	Baa	A	B1+
Arkansas Power & Light Co. 1st and Ref. 5's, 1956	12	11,730	97¾	86	A	A	A	A
Associated Electric Co. 4½'s, 1953	200	169,750	84⅞	48	....	††	A	B1+
Associated Gas & Electric Co. Deb. 5's, 1968	170	142,800	84	21½	A	††	B1	B
Brooklyn Edison Co. Gen. 5's, 1949	12	12,555	104⅝	106	Aaa	Aaa	A1	A1+
Brooklyn Union Gas Co. Cons. 5's, 1945	12	12,705	105⅞	109⅜	Aaa	Aaa	A1+	A1+
Carolina-Georgia Service Co. 6½'s, 1932 w.w.‡‡	45	36,000	80**	...	....	....	D1*	....
Carolina Power & Light Co. 5's, 1956	12	12,180	101½	65¼	Aa	Baa	A	B1+
Chicago Railways 1st 5's, 1927—Stamped	300	205,500	78½§§	52§§	Ba	††	B	B
Cincinnati Gas & Electric Co. "A" 4's, 1968	12	10,740	89½	98¾	Aaa	Aaa	A1+	A1+
Commonwealth Edison Co. 1st "D" 4½'s, 1957	15	14,400	96	100	Aaa	Aa	A1+	A1+
Consolidated Gas Co. of New York 5½'s, 1945	12	12,690	105¾	106⅝	Aaa	Aa	A1	A1
Consolidated Gas Utilities Co. 1st 6's, 1943	140	124,600	89	26½	Ba	B	B*	C1+*
Federal Light & Traction 1st 5's, 1942	10	9,325	93¼	61½	A	Baa	A	B1+
Florida Power & Light 1st 5's, 1954	220	192,500	87½	62¼	Baa	Baa	B1+	B1
Georgia Power Co. 1st and Ref. 5's, 1967	10	10,025	100¼	85⅞	A	A	A	B1+
Illinois Power & Light Corp. 5½'s, "B" 1954	12	12,120	101	63	A	Baa	B1+	B1+
Indianapolis Power & Light Corp. "A" 5's, 1957	12	12,000	100	92⅜	A	A	A*	A
Kentucky Fuel Gas Corp. 6½'s, 1938	80	48,800	61	2**	....	††	C1*	D*
Louisville Gas & Electric Co. of Kentucky, "A," 5's, 1952	12	12,345	102⅞	104⅜	Aa	Aa	A1	A1
Milwaukee Electric Railway & Light Co. "B," 5's, 1961	10	10,037	100⅜	78	Aa	Baa	A	B1+
Minnesota Power & Light Co. 1st and Ref. 4½'s, 1978	12	11,100	92½	75½	A	A	A	B1+
Montana Power Co. 1st and Ref. 5's, 1943	12	12,315	102⅝	83	Aa	A	A1	A
New England Power Association 5's, 1948	120	106,200	88½	56	A	Ba	B1+	B1+
New Orleans Public Service 5's, 1952	65	55,900	86	59	A	Baa	A	B1

For footnotes, see first page of Exhibit.

EXHIBIT 5. (*Continued*)

Issue	Number of Bonds Owned	Market Value June 30, 1930	Prices† June 30, 1930	Prices† December 31, 1932	Ratings Moody's‡ 1930	Ratings Moody's‡ 1932	Ratings Standard Statistics§ 1930	Ratings Standard Statistics§ 1932
Utilities—(*Continued*)								
New York Edison Co. "B" 5's, 1944	10	$ 10,450	$104½	$ 107	Aaa	Aaa	A1	A1+
Niagara Falls Power Co. 6's, 1932	10	10,250	102½	....	Aaa	....	A1	....
Northern States Power "A" 5's, 1941	12	12,180	101½	102¾	A	Aa	A1	A1
Northern Utilities Co. 1st "A" 6's, 1943 w.w.	50	41,500	83	32	Ba	Ba	C1+*	C1+*
Pecos Valley Power & Light Co. 6½'s, 1937 w.w.	50	48,000	96	32	Ba	B	B*	C1*
Philadelphia Co. "A" 5's, 1967	12	12,045	100⅜	86½	A	A	A	A
Postal Telegraph & Cable Corp. 5's, 1953	10	9,200	92	22¾	Baa	B	A*	B
Southeastern Power & Light Co. 6's, 2025	12	12,660	105½	68	A	Ba	B1	B1
Southern Natural Gas 1st 6's, 1944 w.w.	80	73,700	92⅛	42¼	....	††	B1*	C*
United Light & Rys. 5½'s, 1952	100	87,500	87½	51½	Baa	Ba	B1	B1
Utah Power & Light 1st 5's, 1944	12	12,090	100¾	66¾	A	Baa	A	B1+
Western Union Telegraph Co. 5's, 1938	12	12,300	102½	68	Aaa	Ba	A1+	A
Total		$1,643,189						
Industrials								
American Smelting & Ref. 1st 5's, 1947	12	$ 12,180	$101½	$ 84⅞	Aa	A	A1+	A1
Atlantic Refining Co. Deb. 5's, 1937	12	12,120	101	102	Aaa	Aa	A1+	A1
Bethlehem Steel Corp. 1st & Ref. "A" 5's, 1942	10	10,225	102¼	86	Aa	A	A1+	A1+
Chile Copper Co. 5's, 1947	20	18,900	94½	35	A	Ba	A	C1+
Consolidation Coal Co. 1st and Ref. 5's, 1950	180	83,250	46¼	6	Ba	Caa	B1	D
Container Corp. 1st 6's, 1946	75	69,375	92½	33¼	Baa	B	B1*	B
Empire Oil & Refining Co. 1st Coll. 5½'s, 1942	100	84,000	84	41¼	Ba	B	B1*	C1+
General Industrial Alcohol Corp. 6½'s, 1944	200	140,000	70	21	...	††	B1*	D1+*
Hudson Coal Co. 1st 5's, 1962	200	135,500	67¾	31¼	Ba	B	B1+*	B
Humble Oil & Refining Co. 5½'s, 1932	12	12,210	101¾	....	Aa	Aa	A1	....
International Paper 1st and Ref. 5's, 1947	300	243,000	81	38	Baa	Ba	B1	B1
Libby, McNeil & Libby 5's, 1942	50	46,000	92	48½	Baa	††	A	B1
Newberry (J.J.) Co. 5½'s, 1940	100	97,000	97	75	Baa	Ba	B1+	B1+
Phillips Petroleum 5¼'s, 1939	250	232,500	93	71½	Baa	Ba	A	B
Remington Rand 5½'s, 1947 w.w.	25	24,000	96	45	Baa	B	B1+	B
Swift & Co. 5's, 1932‖	25	25,125	100½	...	A	....	A1	....
Texas Corp. Deb. 5's, 1944	100	102,750	102¾	93	Aa	A	A1	A
Ulen & Co. 6's, 1944	200	182,000	91	14½	....	††	B1+*	C1+*
Western Electric Co. Deb. 5's, 1944	12	12,420	103½	99⅞	Aaa	Aa	A1+	A1+
Total		$1,542,555						
Grand Total		$4,240,535						

For footnotes, see first page of Exhibit.

CORN EXCHANGE BANK TRUST COMPANY

APPRAISAL OF A BANK'S BOND PORTFOLIO POLICY

In the *American Banker* for January 9, 1939, and for January 23, 1940, there appeared lists of the securities, and the amounts of

EXHIBIT 1

Corn Exchange Bank Trust Company, Distribution of Bond Portfolio, as of December 31, 1938, and December 31, 1939
(In percentages of total bond portfolio; at par values)

	1938	1939
By Type of Issuer or Guarantor		
United States Government	86.6	81.4
Canadian Government	1.8	3.0
States, Counties, and Municipalities	1.9	1.3
Other Political Districts	1.8	3.6
Railroads	3.3	3.7
Public Utilities	3.1	4.7
Industrials and Others	1.5	2.3
	100.0	100.0
By Years to Earlier of Call or Maturity Dates*		
0.0–4.9 Years	16.5	5.1
5.0–9.9 Years	8.8	8.8
10.0 Years and Over	74.7	86.1†
	100.0	100.0
By Moody's Ratings		
Aaa	87.0	82.5
Aa	3.1	5.5
A	4.9	4.7
Baa	3.4	5.5
Ba	0.9	1.0
B	0.3	0.4
Unrated	0.4	0.4
	100.0‡	100.0‡

* Where municipal bonds maturing in series are owned, but specific amounts for each maturity date are not given, the entire amount has been considered as maturing at the earliest date.

† 84.4 % of the United States Government securities were of over 10 years to the earlier of call or maturity dates.

‡ Total portfolio at par value on December 31, 1938, was $166,761,000; on December 31, 1939, it was $160,515,000. The 1938 portfolio was 104 % of that in 1939.

each at par value, held by the Corn Exchange Bank Trust Company at the close of business on December 31, 1938, and December

EXHIBIT 2

Corn Exchange Bank Trust Company, Comparison of Valuations of Bond Holdings on December 31, 1939*†

Type of Bond	Face Value	Market Value	Book Value‡
United States Government Securities......	$130,760,000	$139,121,818.75	$130,749,750.00
Canadian Government Securities............	4,757,000	4,231,897.50	4,732,392.50
State, County, and Municipal Bonds.........	2,097,000	2,085,592.82§	2,085,592.82
Other Political District Bonds...............	5,750,000	5,968,000.00	5,741,787.50
Railroad Bonds.........	5,952,000	4,957,278.75	5,914,977.50
Public Utility Bonds.....	7,557,000	7,439,332.50	7,507,063.47
Industrial and Other Bonds.............	3,642,000	3,779,215.00	3,587,745.97
Total...............	$160,515,000	$167,583,135.32‖	$160,319,309.76

* Source: Compiiod and computed from iesuee of the *American Banker* for January, 1940.

† Additionai bonde not paying interest, which were segregated into a "Sundry Securitiee" account are not inciuded in thie tabulation. On December 31, 1939, thie account wae carried on the booke at $322,435 but had a quoted market value of $422,044.

‡ Value, after deduction of reeerves, as ehown in a paid display advertisement, which appeared on page 2 of the *American Banker* for January 23, 1940, giving a etatement of condition ae of December 31, 1939.

Through 1938, bonds purchaeed beiow par were carried on the bank's booke at cost and bonde purchaeed above par at par vaiue. Premiume written off were charged againet undivided profite at the time of purchaee; any profits from eaies above book vaiue were credited to undivided profits; interest received from coupons wae credited to income.

Under a new pollcy, instituted in 1939, bonds purchased above par were carried at cost as reduced by monthly amortization of the premium. A premium reserve was estabiished, to be maintained in an amount cquai to the excees of book over par valuc. Of the Interest recelved from coupons, only the yieid amount was carried to income.

§ Owing to the difficulty of allocating vaiuations to epecific bonde of issues having serial maturities, when quotations easliy availablo ln publiehed sources are given only for the beginning and ending maturity of the series, it has been aeeumed for the purposes of thie tabie that these etate, county, and municipai bonds are currently vaiued in the market at the book value.

‖ This total is not exact, eince it includes the book vaiue of the state, county, and municipal bonds and not the true market value, which could not eaeily be obtainod.

30, 1939. The distribution of the bond[1] issues in the portfolio, as calculated for each of those years, is given in Exhibit 1. Face, market, and book values are compared, for 1939, in Exhibit 2. In addition to the bonds listed, the bank held on each date 18,000 shares of stock of the Federal Reserve Bank of New York, 2,499 shares of the Discount Corporation of New York, and 9,900 shares of the Corn Exchange Safe Deposit Company. Bonds not paying interest had been transferred to a "Sundry Securities" account at the current market price, the difference between that price and book value being charged off against undivided profits.

[1] Throughout this case, the words "bond" or "bonds" include Treasury bills, Treasury notes, and other notes in the form of an investment security; and the words "United States Government securities" include both direct and guaranteed obligations.

EXHIBIT 3

Statement of Condition of the Corn Exchange Bank Trust Company at the Close of Business on December 30, 1939*

	(000,000 omitted)	Percentage of Resources†
Assets		
Loans and Discounts (including $18,262.97 overdrafts)	$ 43.7	11.7
United States Government Obligations, Direct and Guaranteed	130.8	35.1
Obligations of States and Political Subdivisions	7.8	2.1
Other Bonds, Notes, and Debentures	22.3	6.0
Corporate Stocks (including $900,000.00 stock of Federal reserve bank)	2.0	0.5
Cash, Balances with Other Banking Institutions (including reserve balances, and cash items in process of collection)	149.7	40.2
Banking Premises Owned	12.1	3.3
Real Estate Owned Other Than Banking Premises	1.9	0.5
Customers' Liability to This Institution on Acceptances Outstanding	1.1	0.3
Other Assets	1.1	0.3
Total Assets	$372.5	100.0
Liabilities		
Demand Deposits of Individuals, Partnerships, and Corporations	$252.0	67.7
Time Deposits of Individuals, Partnerships, and Corporations	26.0	7.0
Deposits of United States Government	0.1	0.0
Deposits of States and Political Subdivisions	14.0	3.8
Deposits of Banking Institutions	41.9	11.2
Other Deposits (certified and officers' checks, etc.)	2.1	0.6
Total Deposits	$336.1	90.3
Acceptances Executed by or for Account of This Institution and Outstanding	1.4	0.4
Other Liabilities	0.9	0.2
Total Liabilities	$338.4	90.9
Capital Account		
Capital‡	$ 15.0	4.0
Surplus	15.0	4.0
Undivided Profits	4.1	1.1
Total Capital Account	$ 34.1	9.1
Total Liabilities and Capital Account	$372.5	100.0

* Source: *The New York Times*, January 8, 1940, p. 25; portions of the published report have been omitted.

† Compiled; not a part of published statement.

‡ This institution's capital consists of common stock with total par value of $15,000,000.

EXHIBIT 4

Selected Data For Various New York City Banks*

<table>
<tr><th rowspan="2"></th><th colspan="4">Percentages of Total Resources, as of December 30, 1939</th><th rowspan="2">Percentage of United States Government Securities Held on December 30, 1939, to Those Held on December 31, 1938</th><th colspan="3">Maturity Distribution of United States Government Securities Held on December 31, 1938</th><th colspan="3">Maturity Distribution of United States Government Securities Held on December 31, 1939</th></tr>
<tr><th>Total Deposits</th><th>Bankers' Deposits</th><th>Cash</th><th>United States Government Securities Held</th><th>0.0–4.9 Years</th><th>5.0–9.9 Years</th><th>10.0 Years and Over</th><th>0.0–4.9 Years</th><th>5.0–9.9 Years</th><th>10.0 Years and Over</th></tr>
<tr><td>Bankers Trust Co.</td><td>90</td><td>29</td><td>33</td><td>41</td><td>130</td><td>56 %</td><td>22 %</td><td>22 %</td><td>53 %</td><td>25 %</td><td>22 %</td></tr>
<tr><td>Bank of the Manhattan Co.</td><td>92</td><td>25</td><td>44</td><td>12</td><td>73</td><td>†</td><td>†</td><td>†</td><td>67‡</td><td>23‡</td><td>10‡</td></tr>
<tr><td>Chemical Bank and Trust Co.</td><td>89</td><td>40</td><td>48</td><td>21</td><td>157</td><td>†</td><td>†</td><td>†</td><td>4</td><td>50</td><td>46</td></tr>
<tr><td>Commercial National Bank</td><td>85</td><td>22</td><td>32</td><td>34</td><td>111</td><td colspan="2">50</td><td>50</td><td>43</td><td>42</td><td>13</td></tr>
<tr><td>Continental Bank and Trust Co.</td><td>86</td><td>17</td><td>40</td><td>7</td><td>75</td><td>36</td><td>64</td><td>0</td><td>29</td><td>71</td><td>0</td></tr>
<tr><td>Corn Exchange Bank Trust Co.</td><td>91</td><td>11</td><td>40</td><td>35</td><td>91</td><td>17§</td><td>10§</td><td>73§</td><td>5§‖</td><td>11§‖</td><td>84§‖</td></tr>
<tr><td>Empire Trust Co.</td><td>91</td><td>10</td><td>29</td><td>22</td><td>100</td><td>63</td><td colspan="2">37</td><td>48</td><td>52</td><td>0</td></tr>
<tr><td>First National Bank</td><td>84</td><td>27</td><td>33</td><td>39</td><td>119</td><td>54</td><td>24</td><td>42</td><td>33</td><td>26</td><td>41</td></tr>
<tr><td>Fulton Trust Co.</td><td>84</td><td>5</td><td>26</td><td>40</td><td>149</td><td>50</td><td>6</td><td>44</td><td colspan="2">70</td><td>30</td></tr>
<tr><td>Guaranty Trust Co.</td><td>85</td><td>25</td><td>44</td><td>31</td><td>150</td><td>78¶</td><td colspan="2">22¶</td><td>84</td><td colspan="2">16</td></tr>
<tr><td>Irving Trust Co.</td><td>86</td><td>29</td><td>50</td><td>21</td><td>88</td><td>100**</td><td>0</td><td>0</td><td>63¶</td><td colspan="2">37¶</td></tr>
<tr><td>Manufacturers Trust Co.</td><td>88</td><td>23</td><td>31</td><td>33</td><td>123</td><td>29§</td><td colspan="2">71§</td><td>37§</td><td>20§</td><td>43§</td></tr>
<tr><td>National City Bank</td><td>89</td><td>24</td><td>38</td><td>31</td><td>110</td><td>61¶</td><td>39¶††</td><td>0††</td><td>67</td><td colspan="2">33</td></tr>
<tr><td>New York Trust Co.</td><td>90</td><td>29</td><td>38</td><td>36</td><td>101</td><td>55</td><td>34</td><td>11</td><td>37‡‡</td><td>45‡‡</td><td>18‡‡</td></tr>
</table>

* Source: Data in the first four columns were compiled from legal statements published by the respective institutions. Data in columns 5, 6, 7, and 8 were compiled from statements, tabulations, and special articles published in the *American Banker* during the months of January, 1939, and January, 1940. Data in the last three columns were compiled from a circular published by Hornblower and Weeks, dated January 25, 1940, except as indicated by footnotes. Data for the Chase National Bank in 1939 were limited to the average maturity: two years and eight months, unchanged from 1938, according to the *American Banker*.

† Not reported.

‡ This distribution is for United States Government securities held on November 30, 1939. In the circular published by Hornblower and Weeks, dated January 25, 1940, it was reported for the Bank of the Manhattan Co., "Two-thirds mature within 5 years, and over 90 % within 10 years."

§ Distributed according to the earlier of call or maturity dates of the issues held.

‖ In the circular published by Hornblower and Weeks, dated January 25, 1940, it was reported for the Corn Exchange Bank Trust Company, "84 % over 10 years, to nearest call date." A separate computation showed that the remaining 16 % was composed of 5 % in the "0.0–4.9 Years" group and 11 % in the "5.0–9.9 Years" group.

¶ For better comparability in this table, the percentages shown are estimates arrived at by prorating data reported on different time bases to the basis used in this exhibit. As published, Guaranty Trust Co. reported, for 1938, 94 % under 6 years; Irving Trust Co. reported, for 1939, 76 % under 6 years; National City Bank reported, for 1938, 67 % under 5½ years.

** Irving Trust Co. reported 100 % under 2 years for December 31, 1938.

†† In the *American Banker* of January 11, 1939, p. 6, it was reported for the National City Bank, "Most of the U. S. securities owned by the bank that are over five years in maturity are less than 10-year maturities . . ."

‡‡ In the circular published by Hornblower and Weeks, dated January 25, 1940, it was reported for the New York Trust Co., "To nearest call date . . . 57.8 % mature within 5 years and 99.9 % in less than 10 years." Percentages given are to maturity dates and are taken from the *American Banker*, January 11, 1940, p. 3.

The report of condition of the Corn Exchange Bank Trust Company published in *The New York Times* on January 8, 1940, in accordance with a call made by the superintendent of banks of the State of New York, is reproduced in part in Exhibit 3.

Additional perspective for use in studying the portfolio policy may be acquired from a comparison of significant data for several New York City banks. The maturity apportionment of the United States Government securities owned by each of a number of New York City banks, together with their holdings of cash, their obligations to all depositors, and their obligations upon bankers' deposits, calculated as a percentage of total resources, are shown in Exhibit 4.

THE FIRST NATIONAL BANK OF MIAMI

ANALYSIS OF A BANK'S BOND PORTFOLIO[1]

While reading the *American Banker* for February 5, 1940, Mr. Wakefield, a stockholder of The First National Bank of Miami, Florida, became interested in a news item which included a list of

EXHIBIT 1

Statement of Condition of The First National Bank of Miami, as of December 30, 1939*

Assets		
Loans to Individuals, Firms, and Corporations in Greater Miami		$ 3,360,342.17
First Mortgages on Improved Real Estate		1,022,893.19
Overdrafts		351.96
Stock—First National Building Corporation—(40 shares)		225,000.00
Stock—Federal Reserve Bank (1,080 shares)		54,000.00
Furniture and Fixtures		125,000.00
Other Real Estate		25,000.00
Other Assets (Accrued Interest and Prepaid Expense)		106,815.15
Commercial Paper Purchased		787,500.00
Bonds Owned (See List)	$14,656,210.32	
Cash Reserve and Due from Banks	15,672,244.90	30,328,455.22
Total		$36,035,357.69
Liabilities		
Capital		$ 1,200,000.00
Surplus, Undivided Profits and Reserves		783,390.05
Deposits		34,051,967.64
Total		$36,035,357.69
United States Government obligations and other securities carried at $8,719,156.25 in the foregoing statement are deposited to secure public funds and for other purposes required by law.		
Deposits—December 30, 1938		$29,262,563.31

* Souce: *American Banker*, January 23, 1940, p. 47.

the maturities of United States Government bonds held by New York City banks. Several banks held bonds which were all under 10 years' maturity; others owned from 40% to 50% in maturities of more than 10 years, one bank having 84% in this class. Mr. Wakefield was puzzled by the diversity of opinion among the New

[1] For an excellent illustration of how a spaced maturities policy would be carried out in practice, see *American Banker*, March 23, 1940, p. 7.

EXHIBIT 2

List of Bonds Owned by The First National Bank of Miami*

Par	Description	Rate	Maturity	Book Value
United States Government Treasury Notes and Bonds				
$ 600,000	U.S. Treasury Notes	1½	6-15-40	$ 607,500.00
750,000	U.S. Treasury Notes	1½	12-15-40	761,250.00
500,000	U.S. Treasury Notes	1½	3-15-41	507,500.00
250,000	U.S. Treasury Notes	1⅜	6-15-41	256,015.63
500,000	U.S. Treasury Notes	1⅛	6-15-43	500,000.00
500,000	U.S. Treasury Notes	1⅛	12-15-43	500,000.00
300,000	U.S. Treasury Bonds	3¼	10-15-45-43	318,000.00
1,000,000	U.S. Treasury Notes	1	3-15-44	1,010,000.00
600,000	U.S. Treasury Bonds	3¼	4-15-46-44	639,000.00
500,000	U.S. Treasury Notes	1	9-15-44	507,500.00
2,000,000	U.S. Treasury Bonds	2¾	9-15-47-45	2,072,720.00
250,000	U.S. Treasury Bonds	2	12-15-47	250,000.00
100,000	U.S. Treasury Bonds	2½	9-15-48	103,125.00
1,500,000	U.S. Treasury Bonds	2¼	12-15-53-51	1,513,437.50
250,000	U.S. Treasury Bonds	2¾	12-15-65-60	250,000.00
30,000	U.S. Savings Bonds		1- 1-47-49	23,100.00
500,000	H.O.L.C. Bonds	2¼	7- 1-44-42	500,000.00
250,000	H.O.L.C. Bonds	1½	6- 1-47-45	253,593.75
2,000,000	F.F.M.C. Bonds	3	5-15-49-44	2,042,500.00
$12,380,000				$12,615,241.88
Other United States Government Securities				
$ 25,000	Federal Land Bank	3	7- 1-55-45	$ 25,000.00
50,000	Federal Land Bank	3	5- 1-56-46	50,562.50
400,000	R.F.C.	⅞	11- 1-41	401,843.75
218,000	R.F.C.	1	7- 1-42	218,984.38
$ 693,000				$ 696,390.63
Industrial Bonds				
$ 25,000	National Steel	3	4- 1-65	$ 25,281.25
50,000	Shell Union Oil	2½	7- 1-54	45,000.00
$ 75,000				$ 70,281.25
Railroad Bonds				
$ 50,000	Chesapeake & Ohio	3½	8- 1-96	$ 47,500.00
25,000	Pennsylvania Co.	4	8- 1-63	25,500.00
$ 75,000				$ 73,000.00

EXHIBIT 2. (*Continued*)

Par	Description	Rate	Maturity	Book Value
	Public Utility Bonds			
$ 25,000	Amer. Tel. & Tel. Co.	5½	11- 1-43	$ 27,062.50
25,000	Penna. Water Power Co.	3¼	12-15-64	26,000.00
20,000	Publ. Serv. of Colo.	3½	12- 1-64	20,400.00
100,000	Sou. Bell. Tel. Co.	3	7- 1-79	100,000.00
$ 170,000				$ 173,462.50
	Foreign Government Bonds			
$ 25,000	Province of New Brunswick	3	7- 1-44	$ 25,000.00
	Florida Municipal Bonds			
$ 25,000	Alachua County	4	1- 1-50	$ 25,000.00
53,000	Dade County	5	10- 1-40-74	53,000.00
5,000	Dade County	3¾	9- 1-40	5,000.00
1,000	Dade County	5	9- 1-45	1,000.00
100,000	Dade County S-D No. 2	4	5- 1-56-63	95,000.00
5,000	Dade County S-D No. 14	4	9- 1-44	5,300.00
50,000	Dade County S-D No. 14	6	5- 1-41-52	50,000.00
10,000	Duval County	5	7- 1-48	10,000.00
22,000	Duval County S-D No. 1	5	4- 1-45	22,000.00
49,000	City of Jacksonville	4½	3- 1-43	49,000.00
1,000	City of Jacksonville	5	11- 1-45	1,000.00
1,000	City of Jacksonville	5	9- 1-49	1,000.00
7,000	City of Jacksonville	3¼	12-15-52	7,000.00
5,000	City of Jacksonville	5	4-15-54	5,000.00
10,000	City of Miami	4½	1- 1-64	9,000.00
90,000	City of Miami	5	1- 1-64	81,000.00
16,000	City of Miami Beach	5¼	4- 1-41-42	16,085.97
5,000	City of Miami Beach	5¾	5- 1-41	5,000.00
3,000	City of Miami Beach	5½	3- 1-42	3,142.13
6,000	City of Miami Beach	6	5- 1-43-45	6,000.00
1,000	City of Miami Beach	5¾	5- 1-47	1,000.00
71,000	City of Miami Beach	4½	1- 1-47-51	71,000.00
1,000	Orange County	5	9-15-43	1,000.00
19,000	Orange County	5	7- 1-48-51	19,000.00
27,000	City of Tampa	4	5- 1-52-64	27,000.00
$ 583,000				$ 568,528.10
	Other State and Municipal Bonds			
$ 25,000	State of Arkansas	3	1- 1-44-49	$ 23,250.00
20,000	State of Arkansas	5	4- 1-70-76	20,000.00
5,000	State of Arkansas	4¾	4- 1-73	4,925.00
50,000	State of Louisiana	4	6-15-53-58	55,165.57
100,000	State of Louisiana	4¼	2- 1-66	114,666.24
50,000	New York City	3	5- 1-50-51	50,000.00
75,000	New York City	2¾	7-15-51-69	69,000.00
100,000	New York City	2½	11-15-56	97,299.15
$425,000				$ 434,305.96

Appreciation of Market Value over Book Value..............$474,205.54

* Source: *American Banker*, January 23, 1940, p. 47.

York bankers, as indicated by these contrasting investment policies. He did not believe that the individual characteristics of the banks could be sufficiently different to warrant such a variety of policies if the bankers all agreed in their judgment of conditions. Hence, he inferred that some of the bankers were not making a correct analysis of the existing circumstances.

Mr. Wakefield did not expect the portfolio of The First National Bank of Miami to be similar to those of New York City banks, because of the great differences in type of customers and in other pertinent factors. Nevertheless, a doubt arose in his mind as to whether the management of the Miami bank had properly evaluated its situation. In an earlier issue of the *American Banker*, he recalled, The First National Bank of Miami had advertised its statement of condition and list of bond holdings. In order to form an intelligent opinion of its portfolio policy, therefore, he decided to make an independent investigation, in so far as was possible from the data readily available. The statement of condition of the bank is given in Exhibit 1 and the bond portfolio in Exhibit 2.

BANK OF BUFFALO

RELATIVE ADVANTAGES OF SHORT-, INTERMEDIATE-, AND LONG-TERM UNITED STATES TREASURY BONDS FOR BANK PORTFOLIOS[1]

Mr. Barlow, president of the Bank of Buffalo, New York, decided in March, 1940, to make a study to determine what had happened to government bonds of different maturities when the market broke in the spring of 1937 and in the fall of 1939. Mr. Barlow's interest in the problem had been stimulated by the discussion of bank portfolio policy at a two-day bankers' conference which he had attended.

Speakers at the conference had urged that banks avoid purchase of long-term bonds and buy only those of 10 years or less to maturity. A few had favored the intermediates, bonds of 5 to 10 years to maturity, over the shorts, under 5 years, in order to get a better yield; others thought the shorts should at least dominate the portfolio. The speakers had pointed to the risk of substantial loss of principal inherent in the longs, since, when interest rates turn up, of the three maturity classifications longs are expected to fall in price the most, intermediates next, and shorts least of all. In support of these assertions, a table was shown which indicated the theoretical effects of rising interest rates on bonds of different maturities. For this table, see Exhibit 1.

Mr. Barlow was not convinced that the conclusions arrived at by the speakers were sound or that the evidence presented in the table was sufficient to support their conclusions. He doubted the apparent assumptions that the yields for all maturities were the same at any given time, and that they necessarily moved together either equally or proportionally. He, therefore, asked the head of the bank's statistical department to determine the relative effects of the market breaks among the different classes of United States Treasury Bonds during the price declines of 1937 and 1939.

[1] Consult: Thomas, Woodlief, "The Banks and Idle Money," *Federal Reserve Bulletin*, March, 1940, pp. 192–200; Griswold, B. H., Jr., "Long-terms Too High for Buying by Commercial Banks," *American Banker*, March 21, 1940, pp. 1, 5; Arthur, H. B., "What Do Bond Yield Differentials Forecast?" *Harvard Business Review*, winter, 1938, pp. 183–187; Williams, J. B., *The Theory of Investment Value*, Ch. XX; Peek, J. H., "Are Short-term Securities a Hedge?" *Barron's*, May 9, 1938, p. 18.

The statistician grouped the bonds according to maturity: those under 5 years, those of 5 years and over but under 10 years, and those of 10 years or more. In calculating these maturity periods for each bond, the beginning dates were taken at the beginning of each decline and the ending dates were the earlier of the maturity or callable dates. For each issue, the price at the end of the market break was deducted from the price at the beginning to find the amount of the decline, which was then expressed as a percentage of the beginning price. These percentages were divided by the yields obtainable upon the respective issues at the beginning dates to find how long it would have been necessary to have held each of the bonds, if bought at the prices existing on the beginning dates, in order that the yield cover the decline in price. It was recognized that such computed holding periods would be much shorter in practice, since most of the bonds would have been bought *before* the beginning dates, and hence at a *lower* price and at a *higher* yield. Portions of the statistician's work sheets for the 1937 and 1939 periods are given in Exhibits 2 and 3, respectively.

To discover how long the shorts, intermediates, or longs, taken as classes, should have been held in order that their yield offset their loss in principal, the statistician computed weighted averages of the price declines and of the yields for each group, and divided the average decline by the average yield. The results of this computation are shown in Exhibit 4. This analysis gave the statistician a basis for comparing the relative advantage or disadvantage of holding each group of bonds.

In addition, the statistician discovered that by assuming the same yields and the same market break, he could find the theo-

EXHIBIT 1

Theoretical Effect of Rising Interest Rates on Bonds of Selected Maturities

Years to Maturity	Cost When Purchased, to Yield 3%	Market Value at End of 1st Year, to Yield 3½%	Market Value at End of 2d Year, to Yield 4%	Market Value at End of 3d Year, to Yield 4½%	Market Value at End of 4th Year, to Yield 5%
3	$100.00	$99.04	$99.03	$100.00	......
5	100.00	98.15	97.20	97.16	$98.07
10	100.00	96.17	93.21	91.08	89.74
15	100.00	94.50	89.94	86.21	83.23
20	100.00	93.10	87.26	82.31	78.15

EXHIBIT 2

Calculation of the Lengths of Time Necessary to Hold Certain Direct Obligations of the Federal Government, of Short-, Intermediate-, and Long-term Maturities in Order That the Yield Earned be Equal to the Loss of Investment Principal in the Bond Price Decline of 1937

Coupon Rate	Issue	Period to Earlier of Call or Maturity from February 9, 1937	Closing Sale Quotation* 2/9/37	Closing Sale Quotation* 4/8/37	Fall in Price	Fall in Price as Percentage of Beginning Price	Yield at Beginning	Years for Yield to Cover Fall
3⅜	1943–40 June 15	3 yrs. 4 mos.	107.8	104.24	$2.50000	2.33	1.15%	2.03
3⅜	1943–41 Mar. 15	4 yrs. 1 mo.	108.6	104.24	3.43750	3.18	1.31	2.43
3¼	1941 Aug. 1	4 yrs. 5½ mos.	108.4	104.27	3.28125	3.03	1.37	2.21
3⅜	1947–43 June 15	6 yrs. 4 mos.	109.12	105.	4.37500	4.00	1.80	2.22
3¼	1945–43 Oct. 15	6 yrs. 8 mos.	108.23	104.16	4.21875	3.88	1.85	2.10
3¼	1946–44 Apr. 15	7 yrs. 2 mos.	108.22	104.14	4.25000	3.91	1.95	2.01
4	1954–44 Dec. 15	7 yrs. 10 mos.	114.22	109.17	5.15625	4.50	1.97	2.28
2¾	1947–45 Sept. 15	8 yrs. 7 mos.	105.26	100.29	4.90625	4.64	2.01	2.31
3¾	1956–46 Mar. 15	9 yrs. 1 mo.	113.15	107.31	5.50000	4.85	2.11	2.30
3	1948–46 June 15	9 yrs. 4 mos.	107.12	102.14	4.93750	4.60	2.12	2.17
3⅛	1949–46 June 15	9 yrs. 4 mos.	108.5	103.5	5.00000	4.62	2.16	2.14
4¼	1952–47 Oct. 15	10 yrs. 8 mos.	120.9	113.25	6.50000	5.40	2.12	2.55
2¾	1951–48 Mar. 15	11 yrs. 1 mo.	104.10	99.22	4.62500	4.43	2.31	1.92
3⅛	1952–49 Dec. 15	12 yrs. 10 mos.	108.8†	103.5	5.09375	4.71	2.38	1.98
2½	1953–49 Dec. 15	12 yrs. 10 mos.	101.19	96.19	5.00000	4.92	2.36	2.08
2¾	1954–51 June 15	14 yrs. 4 mos.	103.13	99.	4.40625	4.26	2.47	1.72
3	1955–51 Sept. 15	14 yrs. 7 mos.	106.23	101.25	4.93750	4.63	2.45	1.89
2⅞	1960–55 Mar. 15	18 yrs. 1 mo.	104.24	99.24	5.00000	4.77	2.55	1.87
2¾	1959–56 Sept. 15	19 yrs. 7 mos.	103.10	98.22	4.62500	4.48	2.53	1.77

* Figures after decimal are 32nds of a point. Quotations are from *The Wall Street Journal* for February 10, 1937, p. 18, and for April 9, 1937, p. 16.
† No sale on February 9. *Last preceding and next following sales occurred on February 6 and February 10, respectively, and were both at $108 8/32.*

EXHIBIT 3

Calculation of the Lengths of Time Necessary to Hold Certain Direct Obligations of the Federal Government, of Short-, *Intermediate-*, and *Long-term* Maturities in Order That the Yield Earned be Equal to the Loss of Investment Principal in the Bond Price Decline of 1939

Coupon Rate	Issue	Period to Earlier of Call or Maturity from July 27, 1939	Closing Asked Quotation*		Fall in Price	Fall in Price as Percentage of Beginning Price	Yield at Beginning	Years for Yield to Cover Fall
			7/27/39	9/25/39				
3⅜	1943–40 June 15	10½ mos.	103.10	103.	$ .31250	0.30	0.00%	Never
3⅜	1943–41 Mar. 15	1 yr. 7½ mos.	105.18	104.20	.93750	0.89	0.00	Never
3¼	1941 Aug. 1	2 yrs.	106.11	105.12	.96875	0.91	0.08	11.38
3⅜	1947–43 June 15	3 yrs. 10½ mos.	110.25	106.20	4.15625	3.75	0.56	6.70
3¼	1945–43 Oct. 15	4 yrs. 2½ mos.	110.20	106.22	3.93750	3.56	0.68	5.24
3¼	1946–44 Apr. 15	4 yrs. 8½ mos.	112.4	106.22	5.43750	4.85	0.63	7.70
4	1954–44 Dec. 15	5 yrs. 4½ mos.	116.2	110.4	5.93750	5.12	0.93	5.51
2¾	1947–45 Sept. 15	6 yrs. 1½ mos.	109.24	103.26	5.93750	5.41	1.10	4.92
2½	1945 Dec. 15	6 yrs. 4½ mos.	108.30	103.10	5.62500	5.16	1.05	4.91
3¾	1956–46 Mar. 15	6 yrs. 7½ mos.	116.2	108.24	7.31250	6.30	1.22	5.16
3	1948–46 June 15	6 yrs. 10½ mos.	111.16	104.16	7.00000	6.28	1.25	5.02
3⅛	1949–46 June 15	6 yrs. 10½ mos.	112.9	105.	7.28125	6.48	1.26	5.14
4¼	1952–47 Oct. 15	8 yrs. 2½ mos.	122.2	113.28	8.18750	6.71	1.40	4.79
2	1947 Dec. 15	8 yrs. 4½ mos.	105.30	99.16	6.43750	6.08	1.25	4.86
2¾	1951–48 Mar. 15	8 yrs. 7½ mos.	110.	101.26	8.18750	7.44	1.51	4.93
2½	1948 Sept. 15	9 yrs. 1½ mos.	109.1	101.12	7.65625	7.02	1.44	4.88
3⅛	1952–49 Dec. 15	10 yrs. 4½ mos.	113.25	105.20	8.15625	7.17	1.67	4.29
2½	1953–49 Dec. 15	10 yrs. 4½ mos.	107.8	99.20	7.62500	7.11	1.73	4.11
2½	1952–50 Sept. 15	11 yrs. 1½ mos.	107.9	99.19	7.68750	7.17	1.78	4.03
2¾	1954–51 June 15	11 yrs. 10½ mos.	109.12	100.16	8.87500	8.11	1.87	4.34
3	1955–51 Sept. 15	12 yrs. 1½ mos.	112.18	102.28	9.68750	8.61	1.84	4.68
2⅞	1960–55 Mar. 15	15 yrs. 7½ mos.	110.	100.17	9.46875	8.61	2.12	4.06
2¾	1959–56 Sept. 15	17 yrs. 1½ mos.	108.19	99.20	8.96875	8.26	2.15	3.84
2¾	1963–58 June 15	18 yrs. 10½ mos.	108.1	99.15	8.56250	7.93	2.23	3.56
2¾	1965–60 Dec. 15	21 yrs. 4½ mos.	108.	99.15	8.53125	7.90	2.28	3.46

* Figures after decimal are 32nds of a point. Quotations are from *The Wall Street Journal* for July 28, 1939, p. 14, and for September 26, 1939, p. 12.

retical period which would just equate the net profit or loss between each pair of groups. The usefulness of this approach would be that if a market break were forecast in less than that

EXHIBIT 4

Comparison of Lengths of Time Necessary to Hold Certain Obligations of the Federal Government of Short-, Intermediate-, and Long-term Maturities, as Groups, in Order That the Yield Earned Be Equal to the Loss of Principal in the Bond Price Declines of 1937 and 1939

	Years to Earlier of Call or Maturity		
	0.0–4.9	5.0–9.9	10 and over
1937			
Fall	2.85%	4.38%	4.71%
Yield	1.28%	2.00%	2.39%
Years for Yield to Cover Fall	2.23	2.19	1.97
1939			
Fall	2.43%	6.20%	7.88%
Yield	0.33%	1.24%	1.96%
Years for Yield to Cover Fall	7.36	5.00	4.02

EXHIBIT 5

Computation of Indifference Periods

	1937	1939
Shorts and Intermediates		
Excess of Intermediates' Fall	1.53%	3.77%
Excess of Intermediates' Yield	0.72%	0.91%
Indifference Period	2.13 years	4.14 years
Intermediates and Longs		
Excess of Longs' Fall	0.33%	1.68%
Excess of Longs' Yield	0.39%	0.72%
Indifference Period	0.85 years	2.33 years
Shorts and Longs		
Excess of Longs' Fall	1.86%	5.45%
Excess of Longs' Yield	1.11%	1.63%
Indifference Period	1.68 years	3.34 years

period, one of the maturity groups would be the better purchase, whereas if no market break were forecast until after that period, the other group would be preferable. If the break were to occur

when the bonds had been held for exactly that period, *either group would show the same profit or loss.* This length of time, therefore, he called the "indifference period." His computations are given in Exhibit 5.

In determining the "ending dates" of the bonds in this analysis at "the earlier of the maturity or callable dates," would it not have been more realistic to take some at maturity dates and others at callable dates, depending upon the yields which would probably obtain as the respective dates approach? More specifically, should one assume, let us say, that after five years all bonds with coupons over 3% would be called on their call dates, others being permitted to run until their maturity dates?

In calculating the gain or loss upon a purchase and subsequent sale of a particular bond, would it be more accurate to use the cash basis of taking coupons at face value for determining income rather than the method of yields used in this case?

Assuming (1) that some bonds of the issues named in this case were to be bought at prices equal to those of July, 1939, (2) that a subsequent market break took the same form and fell to the same extent as the break ending in September, 1939, and (3) that the bank either elected or was forced by circumstances to sell the bonds at that point, which of these bonds would prove to be the most profitable holdings if the bottom of the break followed purchase of the bonds at the end of one year? Of two years? Of three years? Of four years?

Would the answers to the foregoing question be different if it were a case, not of bonds sold, but rather of bonds held during an examination of the bank by the agents of the supervising authorities and without benefit of the understanding[1] that examiners will value bonds at amortized costs?

Describe the actual or probable forces of demand and supply which determined the levels and patterns of the bond market at the "top" and at the "bottom" in each of the declines of 1937 and 1939.

Were the declines of 1937 and 1939 typical of other bond market declines? To what extent should the characteristics of the declines of 1937 and 1939 be used in forecasting subsequent breaks?

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[1] For the examination rule, see Miller National Bank, *supra.*

When an investment policy has been established by a bank, how is its choice of bond maturities limited thereby?

In selecting bond maturities, what importance should be attached to current investment psychology? To size and frequency of market breaks? To prospective changes in interest rates? What additional considerations would be pertinent to this problem?

AMES NATIONAL BANK

APPRAISAL OF BOND PORTFOLIO AS COLLATERAL

Early in November, 1931, the Ames National Bank, located in the village of Freeman, Vermont, requested a loan of $65,000 from the Turner Trust Company of Boston. It offered as collateral to the loan such bonds as the correspondent wished to select from the investment portfolio of the bank, shown in Exhibit 1. The cashier of the bank stated that the funds were needed to meet withdrawals of deposits and that very probably more would be needed within a short time. He asked how much could be borrowed for six months with the entire portfolio as collateral.

The Turner Trust Company had had the major correspondent account of the Ames National Bank for a number of years. Balances averaged over $15,000, and the bank's securities were held in safe-keeping by the trust company. The account had been profitable, although a considerable number of cash and collection items were handled.

In addition to the deposit relationship, the bank had been an active customer of the trust company's bond department during the late 1920's. The cashier of the bank had made it a policy to accept the advice of salesmen of the bond department and of other reputable dealers with respect to the purchase of bonds, as he believed himself unfitted by experience to judge the value of securities. His only requirement was that the bonds purchased yield about 6% in order to cover the 5% interest being paid on savings deposits.

In November, 1931, the depreciation of market value under book value of the bonds held by the bank was equal to the bank's surplus and about 90% of its capital. The cashier stated that there were no funds available locally to make up the deficiency, but that negotiations for a merger with a neighboring institution were under way. Consummation of the proposed merger, however, depended upon the occurrence of a rise in bond prices. The plan was that the intervening period should be tided over by borrowings.

EXHIBIT 1

Bond Holdings of the Ames National Bank, as of November 8, 1931

Issue	No. of Bonds Held	October 31, 1931 Market Price	October 31, 1931 Market Value	No. of Bonds Sold in October*	Range of Sale Price, 1931*	Market†	Rating in Fitch 1931 Bond Book‡
Alexander Building Corp. (Montreal) 1st S.F. 6's, 1947	5	52–62	$ 2,600	......	....	Can	....
American Rolling Mill Co. S.F. Deb. 5's, 1948	5	62–64	3,100	88	60 Oct. 97¾ Feb.	C	BBB
Associated Gas & Electric Co. Cons. Ref. Deb. 5's, 1968	10	48	4,800	1,480	40 Oct. 80¼ Feb.	C	BB
Bangor & Aroostook R.R. Cons. Ref. 4's, 1951	1	60–75	600	2	84 Sept. 94 Oct.	S	AA
Beauharnois Power Corp. Coll. Tr. S.F. 6's, 1959 w.w.	5	58–62	2,900	......	....	Can	X
Boston Elevated Ry. Deb. 4½'s, 1941	4	86⅞ bid	3,475	......	....	O	A
Calgary Power Co. 1st 5's, 1960	5	75	3,750	......	....	Can	A
Canadian National Ry. Guar. 4½'s, 1956	6	82	4,920	602	75 Sept. 100⅞ July	S	AAA
Canadian Northern Power Co. Coll. 5's, 1953	5	64–67	3,200	......	....	Can	....
Canadian Power & Paper Investments Ltd. Deb. "A" 5's, 1958	5	50–60	2,500	......	....	Can	X
Catholic Schools of St. Lambert 5's, 1932	2	No bid	....	......	....	Can	....
Chicago Rock Island & Pacific Ry. 1st & Ref. 4's, 1934	5	80	4,000	1,271	73 Oct. 99½ Jan.	S	AAA
City of Berlin Ext. S.F. G. 6's, 1958	10	30	3,000	411	22 Sept. 84 Mar.	S	BBB
City of Duisburg Ext. G. 7's, 1933	5	26–30	1,300	......	....	O	BBB
City of Duisburg Ext. G. 7's, 1935	5	26–30	1,300	......	....	O	BBB
City of Montevideo Ext. S.F. G. "A" 6's, 1959	5	26¼	1,312	46	18½ Oct. 84¾ Apr.	S	BBB
City of Munich Ext. 7's, 1934	5	37½–40	1,875	......	....	O	BBB
City of Rio de Janeiro Ext. Sec. S.F. G. 6½'s, 1953	5	16¾	837	274	10 Oct. 68 Mar.	S	B
City of Rome Ext. S.F. G. 6½'s, 1952	2	72	1,440	566	60¼ Sept. 91¼ Mar.	S	BBB
Continental Gas & Electric Corp. Deb. "A" 5's, 1958	5	66¼	3,312	898	65 Oct. 88¼ Mar.	C	BBB
Denver & Rio Grande Western R.R. Ref. & Imp. "B" 5's, 1978	5	42¾	2,137	282	20 Oct. 85¾ Jan.	S	BBB
Detroit, Ypsilanti, Ann Arbor & Jackson Ry. 5's, 1926	5	1 bid	50	......	....	O	....
Dominion of Canada Victory 5½'s, 1933	10	90½–92	9,050	......	....	Can	AAA
Dominion Power & Transmission Co. 1st 5's, 1932	6	96–99	5,760	......	....	O	....
Donnacona Paper Co. 1st S.F. "A" 5½'s, 1948	5	35–45	1,750	......	....	O	CCC
Great Lakes Paper Co. 1st S.F. "A" 6's, 1950	5	16–20	800	......	....	O	CCC
Grey Nuns of Montreal 1st 5½'s, 1932	10	No bid	....	......	....	O	...
Illinois Power Co. 1st "A" 5's, 1933	5	96 bid	4,800	......	....	O	AA
Interborough Rapid Transit Co. 1st & Ref. 5's, 1966	10	55	5,500	793	50 Oct. 77¾ June	S	BB
International Securities Corp. of Am. Deb. 5's, 1947	10	54⅜	5,437	416	43½ Oct. 78¾ Feb.	C	X
Kingdom of Denmark Ext. G. 4½'s, 1962	15	71–75	10,650	320	59¾ Sept. 100⅛ Jan.	S	AA
Lake St. John Power & Paper Co. 1st S.F. "A" 6½'s, 1947	5	50 bid	2,500	......	....	Can	X
Lovat Steamship Co. (Pictou, N.S.) 1st 7's, 1933	5	No bid	....	......	....	O	....

EXHIBIT 1. (*Continued*)

Issue	No. of Bonds Held	October 31, 1931		No. of Bonds Sold in October*	Range of Sale Price, 1931*	Market†	Rating in Fitch 1931 Bond Book‡
		Market Price	Market Value				
Mississippi Power & Light Co. 1st 5's, 1957	10	81¼	$ 8,125	115	77 Oct. 98¼ Mar.	C	A
Montreal Island Power Co. 1st S.F. "A" 5½'s, 1957	5	50 bid	2,500	......	....	Can	X
Montreal Rail & Water Terminals Ltd. 1st S.F. 6½'s, 1951	10	5 bid	500	......	....	O	X
Mortgage Bond & Trust Co. (Atlanta) 1st 5½'s, 1946	10	72 bid	7,200	......	....	O	....
New York, New Haven & Hartford R.R. Non-conv. Deb. 4's, 1955	5	62⅞–70	3,143	7	70 Oct. 88 Mar.	S	A
Nova Scotia Light & Power Co. 1st S.F. "A" 5's, 1958	5	75–85	3,750	......	....	O	A
Phillips Petroleum Equip. Tr. 5's, 1932	10	96 bid	9,600	......	....	O	A
Phillips Petroleum Co. S.F. Deb. 5¼'s, 1939	10	55½	5,550	320	50½ May 92¼ Jan.	S	BB
Province of Buenos Aires Ref. Ext. S.F. 6's, 1961	15	33½–40	5,025	412	19½ Oct. 83½ Mar.	S	BB
Province of New Brunswick 6's, 1936	10	104–106	10,400	......	....	O	§
Province of New Brunswick 4¾'s, 1955	5	75–85	3,750	......	....	O	§
Reliance Grain Co. 1st & Coll. S.F. "A" 6's, 1948	5	60 bid	3,000	......	....	O	B
Ruhr Chemical Corp. S.F. Mtge. "A" 6's, 1948	9	40 asked	3,600	......	66⅝ Jan. 66⅝ Jan.	B	B
Seattle (Municipal) Light & Power Deb. 5's, 1955	10	No bid	....	......	....	O	....
State of Parana (Brazil) Ext. S.F. Cons. 7's, 1958	10	12–14	1,200	69	9⅛ Oct. 54½ Mar.	C	B
Terni Co. 1st Hydro-Electric S.F. G. "A" 6½'s, 1953 w.o.w.	5	60	3,000	147	45 Oct. 87 Mar.	C	X
Tokyo Electric Light Co. 1st Dollar 6's, 1953	10	62⅛	6,212	1,287	57 Oct. 91¾ May	S	BBB
Town of Woodstock, N.B. 5's, 1932	1	No bid				O	
United Fuel & Supply Co. 6's, 1936	5	No bid	....	......	....	O	....
United Light & Railways Co. Deb. 5½'s, 1952	5	65	3,250	509	62⅛ Oct. 92 July	C	BBB
United States of Brazil Ext. S.F. 6½'s (of 1927), 1957	15	27½	4,125	413	18 Sept. 70 Mar.	S	BB
Washington Water Power Co. 1st Ref. S.F. 5's, 1939	5	99¾–102	4,987	11	99½ Oct. 105 Jan.	S	AAA
Total	371		$187,572				

* For bonds traded on New York Stock Exchange, New York Curb Exchange, or Boston Stock Exchange, source: *Bank and Quotation Record*, November 6, 1931. For other bonds, local brokers estimated prices but could not supply data for range or turnover.

† Meaning of abbreviations: S, New York Stock Exchange; C, New York Curb Exchange; B, Boston Stock Exchange; O, over the counter; Can, Market in Canada only.

‡ "Investment and semi-investment values, AAA, Highest; AA, High; A, Sound; BBB, Good; BB, Good; B, Speculative; X, Insufficient data on which to base a rating. Speculations based on value in current or indicated readjustment: CCC, Good; CC, Good; C, Fair; DDD, Low; DD, Small; D, Slight or Nil."

§ Other issues of the Province of New Brunswick are rated AA.

The officer of the trust company who handled the account of the Ames National Bank decided that the appraisal of the collateral offered should be made as liberal as possible. He knew that it was the general policy of the trust company to require a margin in market value of 30% of a loan secured by bonds as collateral. He felt, however, that a special study of the collateral offered in this case might permit an even more generous advance. Also, he knew that the bank's deposit balance could be viewed as a part of the basic security for the loan.

12. STOCKS

NORTHWESTERN TRUST COMPANY

INVESTMENT OF PART OF A BANK'S FUNDS IN COMMON STOCKS[1]

Under the national banking laws, national banks are not empowered to purchase common stocks,[2] but under certain of the state banking laws this power exists. A trust company chartered in Massachusetts may "invest its money or credits, whether capital or general deposits, in the stocks, bonds or other evidences of indebtedness of corporations or of associations or trusts."[3] In the investment of savings deposits, however, Massachusetts trust companies are limited to securities which have been approved as legal for savings banks in Massachusetts. The policy of Massachusetts trust companies in regard to purchasing common stocks has varied widely. Some companies never have purchased any stocks, many have purchased small lots from time to time, and a few have adopted a definite policy of investing part of their assets in equity issues. Railroad and bank shares, especially the stocks of the large Boston and New York banks, have been the most popular investment media.

The Northwestern Trust Company never had purchased stocks, but in January, 1928, a change of policy was being considered. The Northwestern Trust Company was located in a western Massachusetts city and had, on December 31, 1927, deposits in the commercial department of $7,972,000. Mr. Dearborn, the president, had recently secured the services of a new vice president, Mr. Knox, who had been placed in charge of the bond portfolio of the bank. Mr. Knox had been employed pre-

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[1] Consult: Rose, D. C., *A Scientific Approach to Investment Management;* Smith, E. L., *Common Stocks as Long Term Investments;* Van Strum, K. S., *Investing in Purchasing Power.*

[2] For the powers of national banks to deal in securities, see case of Miller National Bank, *supra.*

[3] Statutes of the Commonwealth of Massachusetts Relating to Trust Companies—General Laws, Ch. 172, Sec. 33. For a summary of state laws on this subject, see "Digest of State Laws Relating to the Purchase of Corporate Stocks by Banks and Trust Companies," *Federal Reserve Bulletin,* July, 1930, pp. 456–465.

viously in the investment department of a large fire insurance company. This company had been purchasing common stocks for many years with excellent results, and Mr. Knox believed that it would be possible for the Northwestern Trust Company to secure a higher return on the funds under his supervision if part of the bonds were sold and the proceeds reinvested in common stocks. Although Mr. Dearborn was not convinced that the Northwestern Trust Company should purchase stocks, he believed that the matter should be given serious consideration, and he asked Mr. Knox to present his arguments at the next meeting of the board of directors.

At this meeting, Mr. Knox reviewed the investment practice of several fire insurance companies, pointing out that the yield on their investment funds had been increased by the high returns obtained from their holdings of common stocks. He then turned to the life insurance companies and laid special emphasis upon the policy of the Sun Life Assurance Company of Canada, contrasting the results obtained by this company, which is allowed to purchase stocks, with those secured by the life insurance companies in the United States, which are not permitted to do so. He believed that a trust company, in purchasing common stocks, should follow the policy of acquiring a broad list of common stocks for permanent holding, looking to growth in income return on the original investment rather than capital appreciation as the reason for making such purchases.

Mr. Knox then presented figures comparing the record of the Northwestern Trust Company with that of the Bosworth Trust Company, as shown in Exhibits 1 and 2. The Bosworth Trust Company had commercial deposits of $9,237,000, and was located in a neighboring city where industrial conditions were similar to those in the Northwestern Trust Company's own city. Neither bank operated a trust department, but both had savings departments. The savings deposits bore approximately the same relationship to commercial deposits in both trust companies. The chief point of difference between the two banks was in the amount and composition of the security portfolio. The security holdings of the Bosworth Trust Company averaged over 50% of the total commercial assets, whereas those of the Northwestern Trust Company averaged about 20%. A large proportion of the Bosworth Trust Company's securities were common stocks, and it was well known that this bank had made large profits on these

stocks over a period of years. Out of these profits, the Bosworth Trust Company had paid extra dividends in the last three years, and, in 1927, it had erected an impressive bank and office building. Both banks were members of the Federal Reserve System.

EXHIBIT 1

Rate of Indicated Net Earnings on Average Total Invested Capital, 1919 to 1927

Year	Bosworth Trust Company	Northwestern Trust Company
1919	22.7%	4.9%
1920	17.2	14.7
1921	2.6(deficit)	.6
1922	8.7	9.9
1923	10.7	10.6
1924	10.8	11.5
1925	48.2	15.7
1926	14.5	17.6
1927	25.5	11.5

In addition to presenting these figures which showed the greater earning power and the larger security holdings of the Bosworth Trust Company, Mr. Knox stated that he had made a study of the monthly statements of the Northwestern Trust Company from 1919 through 1927. This study disclosed that the item, Other Bonds and Stocks, had never fallen below 8.9% of the total assets applicable to the commercial department, and that the total investment in securities, including United States Government bonds, had never fallen below 13.5% of such assets. Both of these percentages were reached in November, 1919, when inflation was nearing its peak and commercial banks had been forced to reduce their security holdings in order to supply credit to their customers. Since 1919 the security holdings had shown a marked upward trend, so that a profitable investment policy was becoming more and more important to the bank, and Mr. Knox stated his belief that the Northwestern Trust Company should set aside 10% of the assets of its commercial department for investment in common stocks.

A further fact brought out by Mr. Knox was that the bond portfolio of the bank contained several blocks of bonds which he classified as speculative, and that the bank had bought bonds convertible into common stock or with warrants giving the holder the privilege of buying stock. The bond ledger showed that in the majority of cases the bank had paid more for such bonds

EXHIBIT 2

Percentage Distribution of Assets of the Commercial Departments, as of December 31, 1919 to 1927

Year	Bosworth Trust Company					Northwestern Trust Company				
	Total Loans	U. S. Government Bonds	Other Bonds and Stocks	Fixed Assets	Cash and Exchange	Total Loans	U. S. Government Bonds	Other Bonds and Stocks	Fixed Assets	Cash and Exchange
1919	33.9%	6.6%	50.5%	0.5%	8.5%	54.9%	8.1%	11.9%	3.7%	21.4%
1920	33.0	4.7	51.8	0.5	10.0	68.4	0.9	14.0	3.2	13.5
1921	31.0	3.2	56.0	0.6	9.2	71.0	1.0	15.4	3.7	8.9
1922	37.9	4.8	52.5	1.9	2.9	66.4	2.9	15.0	3.2	12.5
1923	35.5	4.7	48.5	1.3	10.0	64.0	2.7	14.2	2.5	16.6
1924	40.5	12.5	36.2	0.9	9.9	64.0	2.8	17.3	2.1	13.8
1925	46.2	12.4	30.2	2.7	8.5	64.0	2.1	12.7	4.2	17.0
1926	37.4	7.7	45.7	3.1	6.1	54.2	1.0	21.6	3.3	19.9
1927	30.5	11.8	42.7	7.2	7.8	60.0	2.2	23.2	3.8	10.8

than the investment status of the issues justified. He believed that it would be more profitable to purchase high-grade stocks than to purchase either low-grade bonds or bonds selling at a premium because of special convertible features. Finally, Mr. Knox pointed out that one of the advantages which a state charter in Massachusetts gave over a national charter was the power to purchase stocks, and that by buying only bonds the Northwestern Trust Company was not utilizing to the fullest extent the powers granted to it.

Should banks buy (*a*) stocks, (*b*) good, but second-grade bonds, at times, (*c*) convertible (semispeculative) or "income" bonds? Is the stock of a company with steady earning power and no bonded debt a better investment than the bonds of a company with variable earnings and a heavy bonded debt? What reasons are there for the general prohibition of stock purchases by banks?

Should banks attempt to secure steady but, on the average, smaller earnings rather than irregular earnings which may average higher in the long run?

How may directors assure themselves as to the competence of a prospective bank officer to be engaged to manage a portfolio of stocks?

What decision should the directors have made in regard to the proposed change in investment policy?

If the purchase of common stocks is approved, what general rules, if any, should be drawn up by the board of directors to govern the selection of such stocks?

IV

ALLOCATION OF ASSETS

13. ALLOCATION OF CASH, CUSTOMERS' LOANS, OTHER LOANS, AND BONDS

WEST END NATIONAL BANK

CUSTOMERS' LOANS VERSUS SALABLES OF SERIAL MATURITIES[1]

In January, 1930, the president of the West End National Bank, a small bank located in an Indiana city of about 20,000 inhabitants, requested a firm of investment bankers to make an analysis of the bank's secondary reserve requirements and security holdings. This investment firm had for a number of years advised banks in the handling of their bond accounts, and it was the president's belief that this experience would be of value to his own institution. The statement of condition of the West End National Bank, as of December 31, 1929, is reproduced in Exhibit 1.

EXHIBIT 1

West End National Bank, Statement of Condition, as of December 31, 1929

Resources		Liabilities	
Loans and Discounts	$ 970,397	Capital Stock	$ 100,000
Bonds and Securities	201,448	Surplus and Undivided Profits	43,113
Mortgages on Real Estate	82,210	Deposits	1,288,000
Cash, Exchange, and Deposits with Other Banks	147,292	Other Liabilities	47,243
Other Assets	77,009		
Total	$1,478,356	Total	$1,478,356

The report, which was received early in February, began with a general discussion of secondary reserve and investment policy, and emphasized the necessity of considering both the general principles and the peculiar circumstances of the individual bank. The need to separate time and demand deposits and to analyze seasonal and cyclical influences was stressed, as well as the fact

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[1] On allocation of assets, see: Young, A. A., *An Analysis of Bank Statistics for the United States;* Hunt, Pearson, *Portfolio Policies of Commercial Banks in the United States: 1920–1939,* Harvard Business School, Bureau of Business Research, *Bulletin No. 24; Federal Reserve Bulletin,* April, 1939, pp. 259–264; Wilkinson, J. H., Jr., *Investment Policies for Commercial Banks,* Ch. III. On the problem of economic stability of location, see Weimer and Hoyt, *Principles of Urban Real Estate,* Chs. 2–4; F.H.A., *Underwriting Manual,* §§901–987, especially §§913–923.

that the existence of several large accounts and of over $200,000 in county and township deposits affected the amount of secondary reserve which the bank should have. A graph showing the fluctuations in the bank's funds over a period of four years was included, and the figures taken from this graph are given in Exhibit 2. After the preliminary discussion, the report continued with a detailed analysis of the problem of the West End. National Bank; the latter part of the report follows:

The principal source of income for a bank like yours, whose operations are commercial in character, is found in the loans and discounts for the customers. You report this item as amounting to $917,344 on January 15, 1930. Attention is called to the fact that such loans and discounts add but little to the liquidity of your bank. The chief way in which they serve in this respect is through their rediscountability with the Federal reserve bank. Judging from data which banks all over the country have submitted to us, we cannot rely upon these assets to any great extent for liquidity.[1]

You will note that your present loans and discounts represent approximately 71% of total deposits. We do not know the nature of these loans or the distribution between the various types of local loans which are probably represented in this total, but we do wish to point out the fact that this ratio is higher than that which we have found in many of the banks which have come to us for analysis. Every bank has an obligation to its community, but it is not wise to concentrate too large a proportion of resources in such assets. We believe that in your case it would be a good idea to make a gradual reduction in your loans and discounts so that they do not represent quite so large a proportion of your total deposits. It will be much easier to maintain a strong liquid position if you will take this step, for it is more than likely that only a small proportion of your present loans and discounts are actually rediscountable. We suggest that you make a careful survey of your position in this respect.

Under the title of other loans and discounts are included call loans, commercial paper, bankers' acceptances, etc. These items, if sound, are usually very liquid. They appropriately form a part of the secondary reserve and are discussed as a part of that subject. According to your data submitted, you do not hold any of the assets listed above in spite of the fact that they are especially attractive for secondary reserve purposes from the standpoint of liquidity.

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[1] [On June 29, 1929, 20% of the loans and discounts of all national banks were eligible for rediscount at the Federal reserve banks. See *Annual Report of the Comptroller of the Currency*, 1929, pp. 35–39; "Paper Eligible for Rediscount at Federal Reserve Banks," *Federal Reserve Bulletin*, July, 1930, pp. 400–410. For the more recent rules as to eligibility for rediscount, see Regulation A of the Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, October, 1937, pp. 984–995.]

EXHIBIT 2

Approximate Monthly Figures for Selected Items, 1926 to 1929*
(000 omitted)

	Total Deposits	Demand Deposits	Time Deposits	Loans and Discounts
1926				
January	$1,110	$ 790	$320	$ 820
February	1,090	770	320	830
March	1,090	770	320	845
April	1,025	710	315	825
May	1,115	805	310	810
June	1,055	740	315	800
July	1,030	720	310	800
August	1,050	745	305	790
September	1,060	760	300	790
October	1,025	720	305	790
November	1,165	860	305	785
December	1,030	730	300	780
1927				
January	1,075	780	295	755
February	1,090	790	300	780
March	1,085	780	305	785
April	1,110	800	310	800
May	1,255	945	310	840
June	1,615	1,205	410	1,260
July	1,595	1,190	405	1,240
August	1,555	1,150	405	1,220
September	1,530	1,130	400	1,250
October	1,520	1,120	400	1,250
November	1,565	1,160	405	1,250
December	1,480	1,080	400	1,240
1928				
January	1,430	1,030	400	1,180
February	1,380	980	400	1,170
March	1,445	1,050	395	1,000
April	1,370	975	395	1,010
May	1,505	1,125	380	1,020
June	1,500	1,130	370	1,045
July	1,490	1,100	390	1,020
August	1,425	1,030	395	1,000
September	1,405	1,025	380	1,090
October	1,525	1,150	375	1,080
November	1,570	1,160	410	1,095
December	1,430	1,030	400	1,080
1929				
January	1,355	960	395	1,060
February	1,325	930	395	1,020
March	1,280	885	395	1,020
April	1,290	890	400	1,000
May	1,380	1,010	370	1,030
June	1,260	900	360	1,000
July	1,280	920	360	990
August	1,320	960	360	980
September	1,315	965	350	1,005
October	1,240	890	350	960
November	1,320	980	340	990
December	1,200	870	330	965

* The increase in June, 1927, was caused by a merger with a smaller bank.

Your bond account, which amounts to $177,250 par value (excluding United States Government bonds), is distributed according to type, as shown in Table A. The distribution of your account according to type is fairly satisfactory, although we believe that you ought to include a group of railroad obligations. The proportion of public utility bonds is slightly above the figure which we consider to be the desirable maximum; therefore, we do not recommend any further increase in this group. Likewise, we do not recommend any increase in the proportion of municipal bonds. A certain proportion of municipal issues is desirable for secondary reserve purposes, but it is not necessary to carry them in your investment account.

TABLE A

West End National Bank, Percentage Distribution of Security Holdings According to Various Classifications

Type		Public Utility†	
Public Utility	33.2	Chicago Railways	50.0
Municipal	23.9	Doherty	8.3
Foreign	10.2	Texas Cities Gas Company	16.7
Real Estate	17.2	Keystone Telephone Company	8.3
Industrial	15.5	Independent	16.7
Quality*		Municipal	
Very Good	3.9	Indiana	83.8
Good	26.8	New York	16.2
Fair	40.5		
Doubtful	13.5		
No Data	15.3	Industrial	
Marketability*		Automobile Parts	50.0
Active	none	Packing	28.6
Broad	19.6	Oil	21.4
Good	29.8	Real Estate	
Fair	21.8	Chicago	73.1
Restricted	13.5	New York	21.8
No Data	15.3	Miscellaneous	5.1

* Excludes municipals.
† Classified according to management.

In our opinion the quality distribution of your securities is considerably below standard. You have approximately 10.2% of the account in the Republic of Mexico 5's which possess only "doubtful" quality, and very nearly 40% is made up of other bonds which in our opinion are entitled to only a "fair" rating. We have been obliged to classify 15.3% of your account under "no data" owing to the fact that we have no information upon which to base a rating. This group includes the C. H. Dotson 7's due 1934 and three of your real estate issues. It seems to us that you have confined your purchases too largely to second-grade issues purchased primarily for yield, and as a result your account is decidedly weak from the standpoint of security.

The marketability distribution is more satisfactory, but you have the "restricted" marketability bonds (Republic of Mexico 5's) and the "no data" bonds, which probably belong in this same classification. While you do not need "active" or "broad" marketability for your entire account, you should be very careful to avoid issues which possess only "restricted" markets.

Please note that in our discussion in regard to quality, marketability, and yield, we have given no consideration to your municipal holdings. No doubt, many of these are special assessment and improvement bonds which possess no general market. Likewise, there are the "no data" bonds, which we have previously mentioned. As a result, we cannot compute an average yield. You will note from Table A that there are certain cases of distortion among your holdings: 50% of your public utility bonds consist of Chicago Railway 5's; 50% of your industrials consist of the one issue of C. H. Dotson 7's, and 73% of your real estate bonds are secured on various Chicago properties. Even though the individual securities which are responsible for these instances of distortion were entirely sound, still the concentration would be undesirable, for it prevents you from obtaining a broad distribution of risk. These factors should be adjusted in the future.

Primary reserve includes the legal reserve which every national bank is required to maintain with the Federal reserve bank of its district, the cash in the vault of the bank itself, the deposits with other banks, and checks, coupons, etc., in the process of collection. With the exception of deposits with other banks, these assets produce no revenue. The interest earned on such demand deposits, while not negligible, is insignificant as compared with the earnings from other assets. The paramount and practically sole object of the primary reserve is to furnish liquidity to the bank, and it does this at the sacrifice of income. According to figures furnished us by you, your primary reserve on January 15, 1930, consisted of the following items:

Primary Reserve
(To nearest dollar)

Cash in Vault of Bank		$ 28,500
Deposits with Federal Reserve Bank		
Reserve Account	$71,302	
Collateral Account	25,369	96,671
Deposits with Other Banks		15,501
		$140,672

The standard for the primary reserve of a national bank of your class is a 12% reserve against demand deposits and a 7% reserve against time deposits.[1] Applying these percentages to the figures of your deposits for the above date as given us by you, you should have a primary reserve of $137,000. This reserve should be quite

[1] [The minimum reserve required by law at that time was 7% and 3%, respectively, against demand deposits and time deposits.]

adequate for your bank, provided you also have an ample, sound, and properly constructed secondary reserve. You will observe on comparing this figure with that of your actual primary reserve that it is substantially the same as the standard set. Your primary reserve, therefore, is well adapted to your needs.

For your bank we compute the standard for a secondary reserve as follows: 35% of the average demand deposits for the preceding 12 months, using as a basis the figures for the 15th of each month as given to us by you, plus 10% of the average time deposits for the same period computed in the same fashion. The application of these percentages gives the figure indicated as standard in Table B, which follows. This standard should be recalculated at six-month intervals.

The composition of the secondary reserve of a bank depends upon several factors, each of which must receive due consideration. The basic factor which must exist to a high degree in all assets in this reserve is *safety*. Every asset which is not thoroughly safe, measured both in absolute terms and in terms of its particular type of security, must be rigidly excluded from consideration.

The second factor involved is *liquidity*, which may be further defined as *marketability* with price *stability*. Practically all assets which would meet the first qualification of safety would be marketable under almost all circumstances, but it might require a substantial sacrifice in price in order to move some of them under certain circumstances. There are several factors which affect the liquidity of securities. One of these is their maturity, for in general, the shorter the maturity, the more liquid is the security.

The third factor is *yield* or income. If this factor could be entirely neglected, then cash in the vaults of the bank or on deposit with large city correspondent banks would meet the needs of the other two factors. While this factor cannot be overlooked, it must be subordinated to the other two in the case of the secondary reserve.

Giving due consideration to all these factors and basing our conclusions on a very careful study of the whole problem, we recommend for the average secondary reserve short-term paper, free United States Government securities, and other readily-marketable bonds of short maturity, due in from one to ten years.

Applying these standards to your situation on January 15, 1930, as revealed in the data submitted to us, we select the assets shown in Table B as suitable for your secondary reserve.

You will note that we have included only the $20,100 United States Government bonds and the $5,000 Burlington Railway & Light 5's, due 1932, as eligible for your secondary reserve. It is possible that certain of your municipal issues might also qualify, but as a general rule special assessment bonds are not sufficiently liquid for this purpose. Your New York City 4½'s are the only "highest" quality bonds in your account, aside from the $20,100 United States governments, but these are long-term bonds, which normally should not be included in a secondary reserve. We do not believe that you could possibly consider any of your other bonds as secondary reserve assets because

TABLE B

Secondary Reserve Assets

(Par value)

Type of Securities	Present Holdings*	Approximate Secondary Reserve Requirements	
		Amount	Per Cent
Call Loans, Commercial Paper, Etc.	$ 0	$175,000	50
United States Government Securities	20,100		
Municipal Bonds	....	35,000	10
Public Utility Bonds	5,000	35,000	10
Railroad Bonds	0	55,000	15+
Industrial Bonds	0	50,000	15−
Foreign Bonds	0		
	$25,100	$350,000	100

* These actual secondary reserve assets are those which, in our opinion, meet the requirements of this account from the standpoints of quality, marketability, and maturity.

they lack both quality and liquidity. We believe that it is absolutely essential that you build up your secondary reserve to our standards as rapidly as possible, especially in view of the fact that your primary reserve is just barely equal to the amount needed for efficient operation under normal conditions. The figures given [in Exhibit 2] indicate that you may very easily encounter conditions in which this primary reserve would not be adequate, and if you happen to experience any such condition at the present time, you have no other assets which could be depended upon for liquidity with price stability.

It is important to have a proper maturity distribution of the secondary reserve assets. The commercial paper and bankers' acceptances should be selected so that, together with the call loans, the bank will have a regular flow of cash coming in from maturing securities of this class.

As we have stated, the maturity of the United States Government securities has little significance from the standpoint of the secondary reserve account, since they perform their function through eligibility to secure loans from the Federal reserve banks.

We wish to call your attention to the absence of any logical investment unit, for you hold blocks of bonds ranging from $100 to $20,000. This lack of a standard investment unit makes it difficult to obtain a proper diversification of the various factors which are essential to well balanced secondary reserve and investment accounts. In your case we believe that an investment unit of $5,000 is suitable, for its use will permit you to include enough issues for broad diversification.

The investment account of a bank is for an entirely different purpose than is a secondary reserve account. The two accounts should be completely segregated. Assets should be selected for the latter

primarily to secure liquidity for the bank. Assets for the former should be chosen to give the bank income, and it should be remembered at all times that safety is the first consideration and that there is no substitute for it. There is no limit to the size to which an investment account may be built other than the amount of funds available for this purpose. As most banks are not permitted to hold stock other than Federal reserve bank stock, except when taken as collateral on a defaulted loan, the investment account is composed primarily of bonds . . . Assets included in this account should be purchased with the idea that they will not be sold unless it appears to be to the advantage of the bank to sell them; that is, they will not be sold under the necessity of obtaining cash funds quickly. Bonds for the investment account should be bought with the expectation of holding them to maturity, unless their sale will result in a profit to the bank, or, in rare instances, unless the position of the bond has been weakened. Of course, it may be desirable to sell some of these bonds for less than the purchase price paid, in order to buy bonds whose price is relatively lower. Such sales should be considered as sales to obtain a profit and not sales at a loss, as the object is to make an ultimate profit for the bank.

In the light of these circumstances, the general rules for building up an investment account are more flexible than are those which should be followed in establishing a secondary reserve account. Bonds may be bought of those maturities which are relatively low priced at any particular time. Flexibility in the composition of this account is also essential to make it possible to purchase at any given time a large proportion of a type of bond which at that moment represents a better value than other types of bonds. In order to obtain a satisfactory average yield, it is desirable to have a larger proportion of public utility, industrial, and foreign bonds than was indicated for the secondary reserve account, to the exclusion of municipal bonds, except a very small proportion of local special assessment bonds with which the officers of the bank are personally familiar in detail. The proportion of railroad bonds may be substantially reduced as contrasted with the recommendations for secondary reserves. A few high-grade issues of real estate bonds which possess national, not merely local, markets may be included. Local individual mortgages from the present standpoint are better considered as a part of the loans and discounts of the bank than as a portion of its investment account. As a guide for the diversification of the investment account from the standpoint of type of bonds, we suggest the following:

Suggested Distribution of Investment Account Bonds

Type of Bond	Per Cent
Municipal Bonds	5–10
Public Utility Bonds	15–30
Railroad Bonds	5–10
Industrial Bonds	10–30
Investment Trust Debentures	5–15
Foreign Bonds	10–30
Real Estate Bonds	5–10

When bonds are selected for the investment account, it must always be remembered that safety of principal is the first consideration; it has no substitute. No bonds in regard to whose fundamental security there is any question should be purchased under any circumstances, and bonds whose credit position appears to be growing weaker should normally be disposed of at once, even at a loss.

It will be observed that we have not set any fixed percentage for the several classes, but have established limits. This has been done not alone to give consideration to individual preference but also to suggest the desirability of changing the distribution of securities depending on the condition of the market. There are periods, for example, when it may be desirable to buy public utility bonds in preference to railroad or industrial bonds. At such times, it is wise to increase the percentage of public utilities toward the upper limit set and to decrease the percentages of the others toward the lower limit . . . From the standpoint of sound diversification, we advise you against decreasing holdings below limits of the percentages which we have set. Each of the several classes of bonds have their merits, and factors which affect one class unfavorably at any particular moment may not affect any of the others . . .

We indicated above that your primary reserve is practically in accord with the standard for your bank. We do not consider this primary reserve adequate, however, because of the fact that you do not have enough secondary reserve securities. You have five accounts with fairly large average balances, and the figures [in Exhibit 2] indicate that your total deposits are subject to rather abrupt fluctuations so that it is imperative for you to strengthen both primary and secondary reserves in order to put your bank in a strong current position . . .

We have pointed out the fact that you have only $25,100 of secondary reserve securities as compared with the $350,000 which we believe you should carry. In addition to this $25,100 in liquid securities, you may be able to depend upon a few of your municipal issues and you may also have some loans and discounts which are rediscountable. These loans and discounts should not be depended upon to any great extent, however, even if you have a large proportion which could be rediscounted, for the character of your local loans is constantly changing . . .

You have very few first-grade long-term bonds; therefore you should watch for any opportunities to readjust the account on a more conservative basis—replacing these issues with short-term paper, United States Government securities, and highly-marketable short-term bonds. You cannot expect to raise much from the sale of your bondholdings and, therefore, we urge you to make a gradual reduction in local loans so as to provide funds for this purpose . . . A list of satisfactory securities is given in Table C.

You will note that Table C includes only high-grade securities of short maturity which are actively traded, so that they can be depended upon to provide liquidity with price stability under most any conditions. A $350,000 account composed of such bonds as these, together with

Table C

List of Bonds Recommended for Purchase*

Security	Rate	Maturity	Approximate Market	Approximate Yield
West Penn. Railway Co	5	1/ 1/31	98	6.25
Japanese Government	4	1/ 1/31	96½	6.22
Milwaukee Electric Railway & Light Co.	4½	1/ 1/31	99⅝	4.92
Michigan Central Railroad	5	3/ 1/31	100	5.00
St. Louis, Iron Mountain & Southern	5	4/ 1/31	100⅛	4.87
Norfolk & Western Railroad	6	5/ 1/31	101	5.15
Republic of Cuba	5½	12/ 1/31	99½	5.75
Niagara Falls Power Co	5	1/ 1/32	100¾	4.65
Toho Electric Power	6	7/ 1/32	99	6.60
Humble Oil & Refining Co	5½	7/15/32	101½	4.75
Swift & Company	5	10/15/32	101½	5.00
Edison Electric Illuminating Co	5	1/15/33	98¾	5.45
Central Gas & Electric Co	5½	2/ 1/33	98¼	6.15
Baltimore & Ohio	4½	3/ 1/33	99⅛	4.85
American Telephone & Telegraph Co	4½	3/ 1/33	99	4.87
A. O. Smith Corp	6½	5/ 1/33	102	5.75
American Waterworks & Electric Co	5	4/ 1/34	100⅛	4.95
Chicago, Rock Island & Pacific	4	4/ 1/34	98	4.57
Virginia Railway & Power Co	5	7/ 1/34	100¼	4.97
Great Northern Railway	4	10/ 1/34	93	5.79
Dominion of Canada	5½	11/ 1/34	101⅜	5.20
Canadian Northern Railway	4½	2/ 1/35	99	4.73
Laclede Gas Light Co	5½	8/ 1/35	100	5.00
State of Bremen	7	9/ 1/35	102	6.65
Standard Gas & Electric Co	6	10/ 1/35	101	5.70
New Orleans, Texas & Mexico Railroad	5	10/ 1/35	99	5.20
Denver & Rio Grande	4½	1/ 1/36	97	5.10
Dominion of Canada	4½	2/ 1/36	98¼	4.85
Midvale Steel & Ordnance	5	3/ 1/36	100½	4.95
Grand Trunk Ry. of Canada	6	9/ 1/36	105	4.98
Humble Oil & Refin. Co	5	4/ 1/37	100¼	4.95
Allis-Chalmers Manufacturing Co	5	5/ 1/37	100½	4.82
Pure Oil Company	5½	8/ 1/37	100	5.50
Cudahy Packing Company	5½	10/ 1/37	96	6.10
German Central Agricultural Bank	6	4/15/38	90	7.75
California Petroleum Corp	5½	11/ 1/38	100	5.50
Armour & Company of Illinois	4½	6/ 1/39	89	6.10
Central Maine Power Co	5	11/ 1/39	100	5.00

* [Data in this table have not been verified.]

your short-term paper and United States Government securities in the proportion indicated above, will put the bank in a strong current position, especially if your loans and discounts are reduced somewhat in order to build up this account. It will be necessary to make this reduction even though it results in a decrease in deposits, for good management demands first a strong current position. You will be obliged to accept an average yield of not higher than 5% from the secondary

reserve, but bear in mind the fact that liquidity is what you need most at the present time if your bank is to be continued on a sound basis. When this account is built up to standard, additional funds can be used for the purchase of long-term bonds which can be selected so as to provide an average return of at least 6% . . .

Are the data, as presented for deposits and loans, adequate for an analysis of probable needs for cash?[1] Using the data presented, estimate the cash and liquidity needs of the bank for the year 1930. What proportion of the total resources is available for income production apart from liquidity needs?

Should the fund available for income production be invested entirely in customer loans if possible? Should it be invested entirely in bonds? Should it be divided between them? Upon what theory or policy and at what point could customer loan volume be too large? What criteria should govern the amount or proportion of general market securities held?

Does the plan proposed for the West End National Bank provide for such factors as: (*a*) the credit needs of the customers; (*b*) the condition of other banks in the same community; (*c*) the relations with correspondent banks; (*d*) the condition of the money market; (*e*) the current and then prospective policy of the Federal reserve banks?

What effect will the adoption of the recommendations have upon the earnings and net worth of the bank?

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[1] See case of Mills National Bank, *supra.*

CLARK NATIONAL BANK

DAILY CONTROL

The Clark National Bank was one of the largest banks in Philadelphia. Decisions as to the allocation of the bank's available funds rested in the finance committee, which was composed of the president and the two senior vice presidents. Each morning this committee received the following reports:

1. A summary of resources, showing the holdings of each type of asset as of the close of business on the preceding day, one day earlier, and one year earlier, and the current gross yield obtainable on each type of asset for the two latest weeks.
2. A statement of the deposit liabilities and bills payable as of the close of business on the preceding day.
3. A schedule of time loans and investments maturing on the day of the committee meeting.

On the basis of this information and known and expected demands for funds in the immediate future, the committee determined what shifts could and should be made between the different types of assets.

On the morning of Friday, January 2, 1931, the finance committee received the daily summary of resources, shown in Exhibit 1, and the daily statement of deposit liabilities and bills payable, shown in Exhibit 2. Time loans and investments which would mature during the first two weeks of January, 1931, were of normal proportions, and the committee did not anticipate any unusually large withdrawals of deposits.

Appraise the bank's distribution of earning assets on December 31, 1930.

Outline the probable reasons for changes which took place in holdings of each important type of asset, and in each subdivision of deposits, between December 31, 1929, and December 31, 1930.

What information, other than that mentioned in this case, would the bank's finance committee find useful as a basis for decisions regarding the current allocation of funds?

EXHIBIT 1

Daily Summary of Resources of the Clark National Bank, as of Close of Business, December 31, 1930 (000 omitted)

	December 31, 1930	Percentage of Total Resources	December 30, 1930	Percentage of Total Resources	December 31, 1929	Percentage of Total Resources	Gross Rate of Int. Rec'd: Week Ending Dec. 27, 1930	Gross Rate of Int. Rec'd: Week Ending Dec. 20, 1930
Cash and Due from Banks								
Cash	$ 658	.22	$ 647	23	$ 701	.26	......	......
Federal Reserve Funds	20,264	6.95	17,604	6.13	17,350	6.32	......	......
Due from Other Banks	10,843	3.72	8,296	2.89	3,410	1.24	‡	‡
Exchange	16,979	5.82	14,418	5.02	23,833	8.68	......	......
Total Cash and Due from Banks	$ 48,744	16.71	$ 40,965	14.27	$ 45,294	16.50	......	......
Reserves								
Call Loans	$ 3,617	1.24	$ 7,583	2.64	....	......	1.52%	1.77%
Bankers' Acceptances	1,253	.43	4,519	1.58	$ 466	.17	1.98	1.98
Government Securities	35,290	12.09	35,757	12.46	14,690	5.35	2.71	2.71
Commercial Paper	1,336	.46	1,474	.51	11	......	3.09	3.08
Time Loans	117	.04	117	.04	......	......	2.41	2.41
Total Reserves	$ 41,613	14.26	$ 49,450	17.23	$ 15,167	5.52	2.46%	2.42%
Investments								
Other Bonds and Securities	$ 36,379	12.47	$ 35,739	12.45	$ 31,188	11.36	4.10%	4.08%
Real Estate Loans	2,761	.95	2,712	.95	2,982	1.09	5.75	5.75
Total Investments	$ 39,140	13.42	$ 38,451	13.40	$ 34,170	12.45	4.21%	4.20%
Customers' Loans								
Unsecured, Firms and Individuals	$ 34,491	11.83	$ 34,974	12.18	$ 41,492	15.11	4.64%	4.64%
Secured, Firms and Individuals	49,491	16.97	49,536	17.26	57,373	20.90	4.99	5.00
Bonds with Repurchase Agreement	5,784	1.98	3,857	1.34	......	......	2.81	2.72
Secured, Brokers, and Dealers	30,778	10.55	31,983	11 14	38,469	14.01	4.09	4.08
Banks and Bankers	8,585	2.94	7,567	2.64	12,923	4.71	5.02	5.04
Total Customers' Loans	$129,129	44.27	$127,917	44.56	$150,257	54.73	4.61%	4.61%
Bank Buildings	$ 3,500	1.20	$ 3,500	1.22	$ 3,500	1.28	11.46%	11.46%
*Total Earning Assets**	$213,382	73.15	$219,318	76.41	$203,094	73.98	4.16%	4.09%
Other Resources†	$ 29,583	10.14	$ 26,746	9.32	$ 26,132	9 52	...	...
Total Resources	$291,709	100.00	$287,029	100.00	$274,520	100.00	......	......

* Excluding cash and due from banks.
† Chiefly customers' liability on acceptances.
‡ Rate for the fourth quarter of 1930 on balances with other banks, 1.61%.

EXHIBIT 2

Daily Statement of Deposit Liabilities and Bills Payable of the Clark National Bank, as of Close of Business, December 31, 1930 (000 omitted)

	December 31, 1930	Percentage of Total Deposits	December 30, 1930	Percentage of Total Deposits	December 31, 1929	Percentage of Total Deposits
Demand Deposits						
Due to Banks....	$ 50,239	22.33	$ 50,262	22.34	$ 43,561	21.37
Individual Demand Deposits..............	116,317	51.70	117,061	52.03	110,359	54.14
Total Demand Deposits.	$166,556	74.03	$167,323	74.37	$153,920	75.51
Time Deposits						
Certificates of Deposit....	$ 26,660	11.85	$ 25,783	11.46	$ 22,953	11.26
Savings Deposits.........	31,768	14.12	31,881	14.17	26,968	13.23
Total Time Deposits....	$ 58,428	25.97	$ 57,664	25.63	$ 49,921	24.49
Total Deposits.............	$224,984	100.00	$224,987	100.00	$203,841	100.00
Bills Payable and Rediscounts*	None		None		$ 6,883	

* Rediscount rate in effect at the Federal Reserve Bank of Philadelphia on December 31 and 30, 1930, 3½%, and on December 31, 1929, 5%.

CLARENCE BANK

DOVETAILING CUSTOMERS' LOANS

In making a periodic review of the bank's portfolio, Mr. Crosgrave, president of the Clarence Bank, observed that while customers' loans were satisfactory in amount at certain times of the year, there were other times when such loans were quite low, leaving the bank with a substantial sum of uninvested funds. Since the net yield obtainable on loans to the bank's customers was higher than on secondary reserve assets or on open-market investments, such as corporation bonds, commercial paper, or Federal Government securities of various types, larger profits could be obtained if the customer loan volume were maintained throughout the year. Mr. Crosgrave whimsically suggested to his directors that the bank should have a revolving fund, constant in amount, of good customer loans. With these loans maturing serially throughout the year, the bank not only would have a better earnings position but could abolish its secondary reserve, and might even be able to reduce its primary reserve (having due regard, of course, for legal requirements and for advertising policy)! He asserted, further, that as portfolio managers they had been "ignorant victims of circumstance" in the past, drifting along with whatever came their way. Instead of accepting such a passive position in the future, he desired that they manage the portfolio by planning and design.

To give effect to this idea, Mr. Crosgrave conferred with Mr. James, manager of the new business department, and said: "Let's stop selecting accounts to solicit because of their deposits; let's solicit accounts with loans—but only those that would fill our period of low loan volume." Mr. James, long accustomed to seeking new deposit accounts by the "shotgun" method of pursuing all prospects within sight, did not share in the president's enthusiasm for the new idea but agreed to cooperate.

At the outset, some difficulty was encountered in trying to determine what businesses might be expected to borrow during the bank's slack lending period. The bank's existing loans, which were concentrated in the months from May to October, were made

largely to woolen mills and wool merchants. Types of industries were to be sought, therefore, whose greatest borrowing activity would occur within the months from November through April. A seasonal study of peaks and troughs in inventories and production[1] was found which gave some information of value, although the correspondence of the borrowing period and peak production was not close. Furthermore, the borrowing period varied among industries because of differences in characteristics, such as distance to sources of raw materials, length of the production period, location and types of markets, and purchase or sales terms.

EXHIBIT 1

Clarence Bank, Seasonal Borrowing Periods of Selected Types of Business Firms

	January	February	March	April	May	June	July	August	September	October	November	December
Woolen Mills					Z	Z	Z	Z	Z	Z		
Wool Merchants					Z	Z	Z	Z	Z			
Roadside Restaurant Chains	X	X	X	X	X	X					X	X
Paper Manufacturers		X	X	X	X							
Women's Shoe Manufacturers	X	X	X	X			X	X	X	X		
Department and Apparel Stores					X	X	X		X	X	X	X

Z = Customers borrowing from the bank.
X = Prospects being considered by the bank.

The seasonal study served merely as a point of departure for a survey made by the bank, which used its numerous connections for acquiring definite information concerning the borrowing seasonals of several companies in each of many industrial groups. As a result, four types of business were found to be potential customers for loans during the desired period. Roadside restaurant chains were borrowers from November through June; paper manufacturers began in February and borrowed through May; women's shoe manufacturers borrowed from January through April and from July through October; department stores and apparel shops also had two seasonal borrowing periods, a minor one from May through July and a major one from mid-September to a peak in late November, ending in December. Mr. James proposed

[1] Kuznets, Simon, *Seasonal Variations in Industry and Trade.* A selection of data from this source is presented in Appendix I, *infra.*

soliciting concerns in each of these groups. Mr. Crosgrave objected to including women's shoe manufacturers because, although they were borrowers from January through April, they were heavy borrowers during the bank's greatest lending season, as shown in Exhibit 1.. He suggested that the department and apparel stores be included, however; for their spring borrowing was light, while their year-end season was heavy, and the latter would supplement the existing peak period of the bank. Meanwhile, the bank should continue to search for other borrowers whose needs would fall primarily during the first four months of the year or during late summer.

A preliminary investigation revealed that most of the companies in the other three types of business were financed adequately, either by security and capital issues or through unbreakable commercial banking relationships. A few were found, however, whose financing needs were apparent and whose business appeared to be within the reach of the bank. Toward these the efforts of the new business department were directed. In the case of several companies, concessions in rates were granted in order to obtain the accounts. These concessions, however, did not impair the credit standard maintained by the bank.

The following year, the president, in reviewing the operation of the new plan, observed that his success in supplementing the portfolio in its weak dates was somewhat restricted by the size of his bank. Had the bank been larger, he could have obtained greater geographical diversification and could have reached a greater number of large concerns. Aside from this limitation, the results were so satisfactory, in his opinion, that he decided to apply the same principle of portfolio balancing to reduce the variation in loans during the longer range recurrent fluctuations of the so-called business cycle. A major problem confronted him in this step, that is, whether or not the slack periods in depression would have to be filled with short-term bonds or whether businesses would borrow heavily during depressions. At least one group could be counted on as borrowers—those companies needing credit for the first time and wishing to borrow to carry them through the critical period. Bankers ordinarily refused to lend in such instances, and Mr. Crosgrave knew that it would be difficult to persuade the lending committee of the bank to grant loans in large volume in any kind of crisis, whether actually the early stages of depression or merely a condition of threatening recession.

This psychological obstacle, he believed, could be surmounted only after a long period of consideration by the officers and directors, and after experimentation on a small scale. In the meantime, he would have to fill in such periods with short-term bonds.

Later on, the president thought, a study could be made by the bank from its own experience with regard to the length of time the loans were outstanding, both seasonally and cyclically, in order that information more exact than that then available could be obtained for use by the bank in achieving its objective. He realized that until this study had been made, no really adequate job of leveling loan volume could be accomplished, and that a number of minor adjustments would have to be made before achieving that end. If a squeeze were to come, however, the bank could rediscount before having to put any pressure on its customers. The president was even willing to rediscount regularly for perhaps a month in each year, if such action would prove to be best for the bank by most nearly permitting a balanced, dovetailed portfolio.

V

EXPANSION AND DEVELOPMENT

14. ORGANIZING A NEW BANK

RANDALL NATIONAL BANK

ESTABLISHMENT AND OPERATION OF A NEW BANK[1]

The Central State Bank was the first and only bank in Randall, Illinois, a residential suburb of Chicago. This institution had been established in 1912, and in 1925 had come under the control of a group of stockholders in the Bradford National Bank of Chicago. The Central State Bank had grown rapidly, as shown in Exhibit 1.

EXHIBIT 1

Deposits of the Central State Bank, as of December 31, 1920 to 1927, and June 30, 1928

Year	Deposits	Per Cent Increase
1920	$1,134,056	......
1921	1,148,769	1.30
1922	1,355,788	18.02
1923	1,450,260	6.97
1924	1,816,613	25.26
1925	2,109,475	16.12
1926	2,378,843	12.77
1927	2,447,509	2.89
1928*	2,473,434	1.06

* Six months.

In the spring of 1928 Mr. Albert Gooch, who was engaged in the investment banking business in Chicago and had lived in Randall for some years, became interested in organizing a second bank in the community. It was his opinion that the Central State Bank had failed to keep pace with Randall's development, and that there was room for a new institution.

[1] See: *Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks,* Ch. I; Trant, J. B., *Bank Administration,* Ch. I; Harr and Harris, *Banking Theory and Practice,* second edition, pp. 21–60; American Bankers Association, Economic Policy Commission, *The Bank Chartering History and Policies of the United States;* Gilmore, E. A., Jr., *The Adequacy of Deposit Banking Facilities in Nebraska,* University of Nebraska Studies in Business No. 39; Hunter and Philip, *Adequacy of Banking Facilities in Colorado,* University of Colorado Business Bulletin No. 40.

In order to be able to present tangible evidence as to the soundness of his views, Mr. Gooch prepared the memoranda shown in Exhibits 2 and 3. He believed that this information would be of value in enlisting the aid of prominent local residents and business men, and that it might also be used in support of an application for a charter.

EXHIBIT 2

Bank Deposits in Selected Cities Tributary to Chicago, as of June 30, 1928

City	Population	Number of Banks	Deposits	Deposits per Capita
Blue Island	13,184	2	$ 6,172,050	$468
Forest Park	13,133	3	4,571,260	348
Harvey	9,931	2	3,318,400	334
Wilmette	7,814	2	4,270,020	546
Winnetka	6,694	3	3,270,010	488
La Grange	6,525	2	5,198,100	797
Elmhurst	4,594	5	4,240,850	923
Hinsdale	4,042	2	2,023,630	501
Total	65,917		$33,064,320	502
Randall	8,781	1	$ 2,473,434	282

The suburbs given have been chosen for this comparative study of bank deposits because: (1) They are roughly similar in size to Randall. (2) Although they are tributary to Chicago, each has, like Randall, a measure of independent business activity and community life. (3) All are located within some 20 miles of the Chicago Loop district. (4) In general characteristics, they range from primarily residential to primarily industrial communities, thus providing a representative cross-section of Chicago's suburban population and its banking needs.

Assuming Randall to be an "average" community, it appears that the size of its population justifies bank deposits of over $4,400,000. Its location, however, 19 miles from the center of Chicago, should give it more than average independence from metropolitan banking competition. In addition, the substantial means of a large portion of its residents might normally be expected to produce bank deposits of well over $500 per capita.

A demand for greatly enlarged banking facilities, in fact, does exist in Randall, but this demand cannot be adequately cared for by a single institution, and it is evident that Randall is seriously "underbanked."

The first person whom Mr. Gooch approached with his project was P. A. Donovan, treasurer of the Donovan Railroad Equipment Corporation. Mr. Donovan was an able executive and was interested in a more rapid development of Randall. His position as an officer in the company which employed over one-half of the city's industrial workers gave him a great deal of influence. He was also one of the organizers of the Randall Country Club, and

EXHIBIT 3

History and Development of Randall, Illinois

The city of Randall was founded in 1891 and incorporated in 1892. The establishment of the original village was tied up intimately with the erection of the first plant of the Donovan Railroad Equipment Corporation, and for many years the life of the community centered around the affairs of this company. Between 1900 and the outbreak of the World War, a few small machine shops and metal-working plants were established in Randall, but in 1915 its population was less than 1,500, and its residents were almost entirely of the laboring classes.

Between 1915 and 1920, manufacturing activity expanded considerably, and the city's population doubled. Since that time industrial growth has been well sustained but not rapid. In 1927 there were 17 manufacturing establishments, employing a total of 702 persons, paying wages amounting to $821,602, using raw materials valued at $1,744,938, and producing finished goods worth $3,612,974. These figures represent a small increase over the corresponding ones recorded in 1920. At present, the Charles Moxham Steel Castings Company is erecting a plant in Randall and will employ some 40 men.

The years 1919 and 1920 marked the beginning of Randall's growth as a residential suburb. As living conditions in Chicago became increasingly congested, and the movement toward the outlying towns gathered force, the natural beauty of Randall's surroundings, and its excellent transportation facilities, did not pass unnoticed. In 1919 a high-class residential subdivision project was undertaken, and work was begun on a golf course. Since then, other real estate developments have been successfully carried through, and Randall has become one of the finest upper middle-class residential communities in the vicinity of Chicago. The extent to which the character of the city has changed in recent years is shown by the fact that the percentage of wage earners in local manufacturing plants to total population declined from 22% in 1920 to 8% in 1927. The increase in population from 2,937 in the former year to 8,781 in the latter has been due almost entirely to this influx of the families of well-to-do men working in Chicago, and there is every reason to believe that this growth will continue.

A new bank in Randall might be expected to obtain some valuable accounts from local manufacturing and merchandising concerns, only one of which is so large that its borrowing needs could not be cared for by an institution with capital and surplus of about $200,000. Deposits from and loans to individuals, however, would constitute by far the major portion of the business of such a bank. The present limited banking facilities in the city have caused many residents of Randall, who actually need a local connection, to leave their accounts in Chicago. Furthermore, there is a steady stream of newcomers moving into the town who are, in the best sense of the word, new business prospects.

his wife was a social leader in the community. Finally, his interest in the new bank would bring with it some extremely valuable business, since the Donovan Railroad Equipment Corporation had withdrawn its account from the Central State Bank in 1926.

Mr. Gooch next discussed the matter with James Robinson, who had inherited the business of J. Robinson & Company, dealers in general merchandise. This store, which had been established in 1892, was a typical small-town shopping center. Mr. Robinson was known to everyone, well liked, and recognized as a politician. He was willing to support a new bank, since the

officers and directors of the Central State Bank had, to a large extent, sided with his opponents on local political issues.

Charles Moxham, the commander of the Randall post of the American Legion, was the third man whom Mr. Gooch took into his confidence. Mr. Moxham recently had left the employ of a large Chicago steel concern and had organized the Charles Moxham Steel Castings Company, which was soon to complete a new plant in Randall.

The last member of Mr. Gooch's informal organization committee was Angus MacGregor. He was a wealthy, retired manufacturer, trustee of a savings bank in an adjoining community, and active in church and civic welfare work in Randall.

The committee thus formed proceeded to a consideration of the following problems:

1. *Charter.*—It was decided to apply for a national charter, primarily because there was some doubt as to whether the Illinois Auditor of Public Accounts would approve the establishment of another state bank in Randall. It was thought desirable to differentiate the new bank from the Central State Bank. Mr. Gooch was acquainted also with officials of the Chicago Federal Reserve Bank, who he hoped would use their influence with the Comptroller of the Currency in obtaining a charter.

The chief argument in favor of a state rather than a national charter was that under Illinois laws a bank could lend 15% of its capital and surplus to a single borrower, whereas the lending limit for national banks was 10%.

2. *Name.*—It was unanimously agreed that, since the organization of the new bank was being undertaken by local men, primarily with the idea of serving the community, the name "Randall National Bank" should be adopted.

3. *Capitalization.*—A lending limit of $20,000 would enable the new bank to accommodate local borrowers, and an original investment of $200,000 would be in line with the volume of deposits which normally might be expected in a city the size of Randall (see Exhibit 2). Capital funds of $200,000 would be smaller than the capital, surplus, and undivided profits of $410,000 of the Central State Bank, but there seemed to be little logic in capitalizing for a larger amount merely because of the size of the competing bank. The organization committee believed that $50,000 of the $200,000 originally invested should be in the form of surplus. It would be advantageous to distribute the stock as widely as possible in order

to obtain the support of a large number of the prominent citizens of Randall. At the same time, since no one group was to retain a majority control of the bank, it was necessary to see that the stock went only to those who would permanently support the undertaking.

It was decided to issue 2,000 shares of $75 par stock, to be sold at $100 per share. Stock was to be offered to selected residents of the community in 5-share and 10-share lots, and it was agreed that no person should purchase more than 10 shares unless his continued loyalty to the bank was beyond question.

4. *Directorate.*—After some objections and arguments, the committee determined, as far as possible, to include in the board of directors representatives of every class of society and every important organization in Randall. The board, as finally constituted, was made up of 18 men, including all 5 members of the organization committee. In addition to prominent men in the business, social, fraternal, and religious life of the community, the following directors deserve special mention:

Mr. N. Miller, a wealthy Chicago real estate operator, who had developed one of the subdivision projects in Randall, and who was intimately acquainted with land values and the condition of the real estate market in the vicinity.

Mr. Joseph Strachila, owner of one of the local machine shops, who was of Polish descent, having worked up to his present position from that of a common laborer and having the admiration and respect of a large number of his countrymen and others employed in the factories in Randall.

Mr. R. E. Vivian, a Chicago lawyer, who lived in Randall, and who had agreed to act as counsel for the bank.

5. *Officers.*—Mr. Donovan and Mr. MacGregor accepted the positions of president and vice president, respectively. Although their titles were largely honorary and carried no compensation, Mr. MacGregor agreed to assume the active supervision of the new bank, and Mr. Donovan promised to give as much time as he could to the new institution.

As cashier and managing officer of the bank, the committee selected Mr. Roth, an able man who had risen from messenger to assistant cashier in a slightly larger institution in a near-by town. He had a thorough knowledge of all the problems connected with the administration of a small bank, and his further rise in the bank from which he had been taken was hampered only

by the rule of seniority. The position of assistant cashier was offered to the son of a local resident whose support the organization committee was anxious to obtain. He was a promising young man with a pleasing personality and several years' experience in credit work in a Chicago bank.

6. *Location.*—The stores and business houses in Randall were grouped in a few city blocks (see Exhibit 4). Sites on Main Street were particularly desirable, and, although there was some expansion taking place along the three principal cross streets, the organization committee was unanimously in favor of Main Street frontage. In recent years the business district had been growing away from the railroad station, and in the direction of the residential district. Hence, a location in this line of growth would be preferable to one in the older part of the city. The Central State Bank was located in the older section, within one block of the railroad station.

It was decided that the new bank should erect its own building. Such a building would give an air of greater stability than would the occupation of leased premises. Also, it would emphasize the fact that the Randall National Bank was a local institution backed by men who were interested in the growth and beauty of the community as well as in improved banking facilities. The committee agreed, however, that if the application for a charter were granted, it would be desirable to open the bank as soon as possible and to rent space in another building until a permanent banking house could be completed.

Having settled these points, the committee proceeded with the details of organization. The first step, taken on August 2, 1928, was to write to the Comptroller of the Currency, requesting that he reserve the title of the Randall National Bank, and stating the amount of the proposed capital and the fact that the bank would be located in Randall.

On August 6, within the 15 days during which title would be reserved, a formal application to organize a national bank was sent to the comptroller. This application was signed by each of the members of the organization committee and by Mr. Roth, giving their residences, occupations, financial strength, number of shares of stock to be subscribed for, and, in the cases of Mr. Gooch, Mr. MacGregor, and Mr. Roth, their banking experience. A list of the proposed officers and directors was enclosed with the application.

A week later, Mr. Gooch, who was acting as secretary for the organization committee, was advised that a national bank examiner from Chicago would call on him to meet the organizers and to investigate the advisability of the establishment of a new bank in Randall. When the examiner arrived, Mr. Gooch submitted to him the information shown in Exhibits 1, 2, and 3, together with a petition signed by 50 influential men in the community, stating that the Randall National Bank would fill a need in the city, and requesting that it be permitted to organize. The members of the committee accompanied the examiner on his inspection tour of the community.

Mr. Gooch made it a point to introduce Mr. Donovan and Mr. MacGregor to his acquaintances at the Chicago Federal Reserve Bank and to keep the bank officials informed of the progress being made in the affairs of the proposed bank. As another means of inducing favorable consideration by the Comptroller of the Currency, Mr. Robinson wrote to a friend in the state government, requesting that he mention the Randall National Bank to the auditor of Public Accounts, whom the comptroller might also wish to consult.

On September 8, Mr. Gooch received word that the comptroller had approved the application of the Randall National Bank and that its organization must be completed within 60 days. Thereupon, the organization committee drew up a subscription contract for stock in the bank and undertook to effect a final placing of the shares. More than half of the total number of shares had been promised to the directors and their friends, and little difficulty was encountered in placing the remainder. The number of shares for which any one person was allowed to subscribe was strictly limited. Mr. Gooch, Mr. Donovan, and Mr. MacGregor each took 50 shares, and the stockholders' list in its final form included 240 persons. The money realized from the sale of stock was deposited in a Chicago bank. Inasmuch as the members of the organization committee did not ask for compensation for their services, and inasmuch as no promoter or promoter's profit was involved, the expense of organizing the bank was negligible and was voluntarily assumed by, and prorated among, the members of the organization committee.

Following the receipt of approval of the application to organize, articles of association and an organization certificate, the latter bearing the names of all stockholders with their addresses,

financial worth, and number of shares purchased, were drawn up. Oaths were administered to directors, and officers were formally appointed. Twelve thousand dollars in stock of the Chicago Federal Reserve Bank was subscribed for,[1] and evidence of the deposit of funds collected on stock subscriptions, as well as copies of the articles of association and the organization certificate, were forwarded to the comptroller.

On September 24 the certificate of authority to commence business was received by Mr. Gooch and was duly published in Randall's weekly newspaper. On October 1 the bank opened for business.

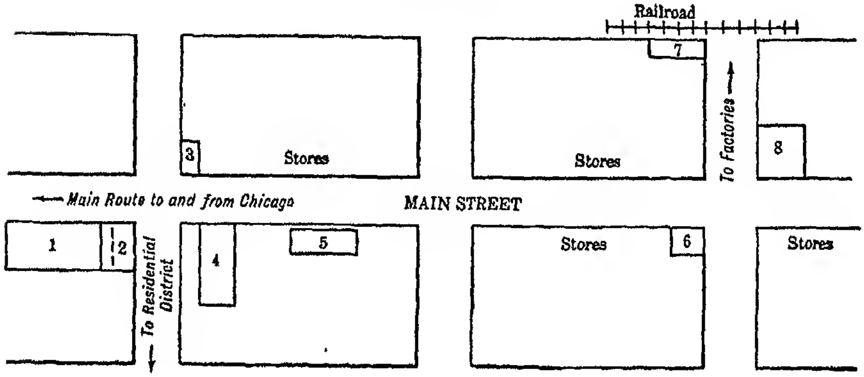
During the time between the drawing up of the organization certificate and the opening of the bank, Mr. Gooch and his associates were concerned principally with soliciting deposits for the new bank and with the problem of a permanent location and a building. In regard to the former, the first step which the organization committee took was to consult with the officers of the Central State Bank regarding the competitive situation in which the institutions would find themselves. The Randall National Bank pledged itself to adhere, in general, to the same rates on loans and the same interest arrangements that were in force at the Central State Bank. Each institution wished to avoid cutthroat competition, realizing that it would be to its own advantage to enter into a more or less friendly rivalry on the basis of service. Accordingly, the representatives of the Randall National Bank decided to offer 2% interest on deposits of more than $500 and to make local loans at 6%. They were able to secure, principally from directors and other stockholders, pledges of over $100,000 for deposit on the day the bank opened, and they also made some progress in obtaining accounts to be opened at a later date.

The matter of a site for the new bank building was settled through Mr. Miller, one of the directors. The frontage on Main Street, indicated by numbers 1 and 2 in Exhibit 4, and occupied by two of the older residences in Randall, appeared to be a highly desirable location for the bank. It was in the line of the city's growth and convenient to both the shopping and the residential districts. The fact that a prominent grocery chain, which chose

[1] According to the Federal Reserve Act, Section 2, only 50% of such subscription must be paid in cash, the remainder being subject to call by the Federal Reserve Board.

its sites with great care, recently had opened a store on the opposite corner, was good evidence of the value of this location. However, the desirable corner lot, 100 feet by 68 feet, was considerably larger than the bank required, and the owner, realizing the value of his land, was asking a price of $45,000, which seemed prohibitively high to the organization committee.

EXHIBIT 4
Location



1. Store building erected on land purchased from Randall National Bank
2. Randall National Bank, including store in building, indicated by broken line
3. Site chosen by prominent chain store company
4. Motion picture theater
5. Post office
6. Central State Bank
7. Railroad station
8. J. Robinson & Company

Mr. Miller suggested that, if the committee purchased both the corner lot and the one adjacent to it which could be had for $27,500, he would agree to pay a reasonable price for the Main Street frontage which the bank did not require. Accordingly, the two lots, 200 feet by 68 feet, were bought, the houses occupying them were demolished, and a lot having 152 feet frontage on Main Street was sold to Mr. Miller for $42,500. On his portion of the site Mr. Miller erected a two-story store and office building.

On the corner lot the bank constructed a stone building, completed during the autumn of 1929, 48 feet by 68 feet, and 25 feet in height. One-third of the building was partitioned off from the bank and was divided into a first and a second floor. Doors were provided connecting this portion with Mr. Miller's adjacent store and office structure. The street level was rented to a shoe store, and the upper floor was divided into two doctors' offices. This space, which was rented by the year, assured the

bank ample room for expansion by the simple process of serving notice on the tenants and removing the partition and floor. The portion of the building originally occupied by the bank also made allowance for growth, four cages, instead of the two immediately required, and large working and vault space being provided. The building, when completed, cost $74,800, including demolition cost of the houses which had occupied the two lots, and complete furnishings and equipment. An investment of $104,800 in fixed assets was large for an institution the size of the Randall National Bank, but an attractive building of ample size had been provided, and some income was realized from the rented portion.

During the first year of its existence, the Randall National Bank grew rapidly and proved unusually profitable for a new institution. Mr. Roth, the cashier, secured many new accounts, and all the directors devoted a great deal of their time and effort to the affairs of the bank. As a result of the rapid expansion in volume of deposits (see Exhibit 5) and the high money rates prevailing during 1929,[1] the bank established itself on an earning basis before the end of six months of operation and showed an excellent profit in the ensuing nine months (see Exhibits 6 and 7). The operating expenses of the Randall National Bank, however, were lower than those which normally would be found in a new institution, because of the absence of senior officers' salaries. Mr. MacGregor attended to the general supervision of the bank and to the granting of credit, Mr. Gooch handled the bond

EXHIBIT 5

Deposits of the Randall National Bank and the Central State Bank on Dates of Call, October 3, 1928, to December 31, 1930
(000 omitted)

Date	Total		Checking		Savings	
	Randall National	Central State	Randall National	Central State	Randall National	Central State
October 3, 1928	$104	$2,481	$ 49	$ 870	$ 55	$1,611
December 31, 1928	414	2,362	254	821	160	1,541
March 27, 1929	490	2,179	306	592	184	1,587
June 29, 1929	563	2,423	346	883	217	1,540
October 4, 1929	543	2,371	306	833	237	1,538
December 31, 1929	678	2,270	408	745	270	1,525
March 27, 1930	707	2,370	378	816	329	1,554
June 30, 1930	732	2,352	384	859	348	1,493
September 24, 1930	755	2,580	413	1,044	342	1,536
December 31, 1930	703	2,403	350	895	353	1,508

[1] See Appendix III.

EXHIBIT 6

Statements of Condition on Dates of Call, October 3, 1928, to December 31, 1930

	October 3, 1928	December 31, 1928	March 27, 1929	June 29, 1929	October 4, 1929	December 31, 1929	March 27, 1930	June 30, 1930	September 24, 1930	December 31, 1930
Resources										
Loans and Discounts	$146,500	$498,813	$542,133	$612,473	$566,555	$610,164	$615,692	$486,299	$484,790	$481,995
United States Securities	....	....	....	....	17,500	17,500	28,000	28,000	35,800	28,000
Other Bonds, Stocks, and Securities	6,000	6,000	6,000	6,000	6,000	6,000	46,308	152,635	161,477	144,447
Real Estate	30,000	30,000	30,000	30,000	....	....	....	....	....	....
Banking House, Furniture, and Fixtures	....	3,211	18,842	47,825	97,639	103,767	104,800	104,800	104,800	104,800
Other Assets	....	1,289	....	....	....	....	....	....	....	....
Cash and Due from Banks	121,759	77,329	97,250	69,564	64,677	148,093	119,487	169,984	179,010	152,351
Total	$304,259	$616,642	$694,225	$765,862	$752,371	$885,524	$914,287	$941,718	$965,877	$911,593
Liabilities										
Capital Stock	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000
Surplus and Undivided Profits	50,000	50,000	51,841	52,096	55,151	53,597	51,896	55,965	54,074	55,857
Reserves for Interest, Taxes, Etc.	....	2,153	2,893	792	3,733	3,622	5,074	3,770	6,088	2,619
Deposits	104,259	414,489	489,501	562,974	543,487	678,305	707,317	731,983	754,815	703,117
Total	$304,259	$616,642	$694,235	$765,862	$752,371	$885,524	$914,287	$941,718	$965,877	$911,593

account, Mr. Miller gave advice regarding real estate loans, and legal matters were taken care of by Mr. Vivian. None of these men asked for, or received, any compensation.

The year 1930 was a more difficult one for the bank. New accounts continued to come in, and deposits held up well during the first three quarters. The local demand for loans, however, fell off, and the sharp decline in short-term money rates cut seriously into earnings. The latter consideration was especially important because the officers and directors felt that it was the part of con-

EXHIBIT 7

Semiannual Income Statements, December 31, 1928, to December 31, 1930, Inclusive

	December 31, 1928*	June 29, 1929	December 31, 1929	June 30, 1930	December 31, 1930
Operating Income					
Interest					
Time Loans	$2,464	$ 6,072	$ 5,730	$ 6,955	$ 6,423
Demand Loans	5,720	10,296	12,408	7,304	3,790
Securities	77	196	196	1,496	2,187
Deposits in Other Banks	352	89	102	451	1,755
Mortgage Loans	......	438	1,759	2,023	3,254
Total Interest	$8,613	$17,091	$20,195	$18,229	$17,409
Commissions and Exchange	6	431	603	770	1,038
Office Building—Net Revenue	......	....	80	603	792
Safe Deposit Vault Revenue	......	64	265	322	273
Total Operating Income	$8,619	$17,586	$21,143	$19,924	$19,512
Operating Expense					
Interest					
Deposits—Commercial and Savings	$ 440	$ 4,847	$ 5,192	$ 6,780	$ 8,278
Borrowed Money	......	2,288	....	....	175
Office Expense					
Salaries and Wages	7,304	3,520	3,728	5,160	5,520
Other		4,902	7,686	3,715	3,313
Taxes	......	13	73	1,498	2,080
Total Operating Expense	$7,744	$15,570	$16,679	$17,153	$19,366
Net Operating Income	$ 875	$ 2,016	$ 4,464	$ 2,771	$ 146
Other Income					
Gain on Security Sales	......	....	....	73	....
Cash Differences and Sundry	......	28	41	17	58
Less Deductions					
Loss on Security Sales	......	....	....	261	45
Cash Differences and Sundry	9	20	174	84	12
Net Income	$ 864	$ 2,024	$ 4,331	$ 2,516	$ 147
Additions to Profit and Loss	$ 864	$ 2,024	$ 4,331	$ 2,516	$ 147
Profit and Loss at Start of Period	......	1,289†	2,096	3,597	5,965
Transfers from Reserves	......	4,507	....	4,091	8,146
Total	$ 864	$ 5,242	$ 6,427	$10,204	$14,258
Less: Transfers to Reserves	2,153	3,146	2,830	4,239	6,995
Write-downs on Loans	......	....	....	....	1,406
Balance in Profit and Loss at End of Period	$1,289†	$ 2,096	$ 3,597	$ 5,965	$ 5,857

* 3 months.
† Loss.

servatism to keep a large amount of funds in cash and short-term securities. They believed that a new bank which did not have an established reputation when public confidence was at a low ebb would be particularly susceptible to runs and should guard against them by maintaining large reserves. In spite of these difficulties, the Randall National Bank continued to make a satisfactory showing.

At the end of its first 27 months of operation, deposits stood at $703,117, while during this period the Central State Bank had failed to make any progress in volume of deposits (see Exhibit 5). By withholding dividend payments, the Randall National Bank, after charging off all organization expenses, had been able to build up its undivided profits to $5,857 on December 31, 1930.

Judging from the evidence presented prior to the opening of the Randall National Bank, was there a need for increased banking facilities in Randall?

On the basis of the progress in volume of deposits made by the Randall National Bank and the Central State Bank between October 1, 1928, and December 31, 1930, does the judgment of the comptroller in allowing the new bank to be established appear to have been vindicated?

Comment specifically on the policies adopted by the organization committee in regard to: (1) type of charter, (2) selection of directors, (3) distribution of capital stock, and (4) investment in fixed assets.

Does, or should, the general type of stockholder in a new bank have any influence on the payment or withholding of dividends? Was nonpayment advisable in this case?

In the light of its December 31, 1930, statement and its earnings for the preceding year, is it true that the Randall National Bank should have kept $50,000 to $100,000 less in cash and short-term securities, and placed these funds in long-term bonds at higher interest rates?

On the basis of the figures given in Exhibit 7, is it possible to arrive at the cost of the $703,117 of deposits shown on the Randall National Bank's December 31, 1930, statement? If so, what was the approximate cost per dollar of these deposits? Was the cost excessive?

Could a more propitious date have been selected for opening the bank? If so, what?

15. PURCHASE OR CONSOLIDATION

KAUFMAN v. MARQUETTE NATIONAL BANK

289 Fed. Rep. 295 (U. S. Dist. Ct. 1922)

PURCHASE OF DEPOSITS AND VALUATION OF GOODWILL[1] AT TIME OF RECHARTER

SESSIONS, J.[2] . . . The charter of the Marquette National Bank expired at the close of the 6th day of October, 1921. At that time its deposits amounted to upwards of $2,100,000. Its loans and bills discounted and other investments were correspondingly large and of an unusually high grade. It was very prosperous, its net earnings amounting to upwards of $40,000 per annum. Its capital was $100,000, its surplus $100,000 and its undivided earnings approximately $27,000; thus making the book value of its shares about $227 per share. The actual market value of such shares was approximately $300 per share. For more than a year before the expiration of the bank's charter, the individual defendants, who constituted its entire board of directors, acting in their official capacity as officers and directors of the bank, had been seeking to devise some plan or scheme whereby plaintiffs and those represented by them might be eliminated as shareholders and, at the same time, the business of the bank continued without interruption or loss. To this end, committees of their own number made trips to Washington, Cleveland, Chicago, and other cities, partly, at least, at the expense of the bank, and there was also an extended correspondence with bankers and bankers' agents located in different places. Two plans were suggested, discussed and considered: The one to renew and to

[1] Goodwill has been defined, as follows: "Money . . . invested in business . . . should bring . . . annual returns . . . ranging from 10% to 50% or more, depending upon the character and conditions of the particular business. The difference between the returns on security investments and the returns on business operations may be designated as 'goodwill' returns, and goodwill may be defined as the profit-producing power of an established business beyond mere interest and replacement returns; or, from another point of view, as the value of an established business over and above the value of its material assets." Conyngton, H. R., *Financing an Enterprise*, fifth edition, Vol. II, p. 340.

[2] Portions of this case are omitted.

extend the charter of the bank, possibly with a change of name, and the other to organize a new bank. The latter plan was finally selected and adopted early in August, 1921.

During August and September and the first six days of October, this plan was secretly, but actively and successfully, carried out and executed. The defendant Union National Bank was organized and incorporated, with a capital of $100,000 and a surplus of $100,000. All the stock in the new bank was subscribed for and taken by the individual defendants, who became its directors. For appearance's sake, two of the individual defendants, who had not been directors of the old bank, became directors of the new. Formal meetings of the boards of directors of the old and new banks were held at the same time and place, and resolutions were adopted authorizing and directing the sale and transfer to the new bank of the business and all of the assets and property of the old bank, except a small amount of slow and doubtful bills and notes receivable. Written conveyances were made accordingly. No meetings of stockholders were called or held, and no notice of what was transpiring was given to plaintiffs . . . As to them, the entire transaction was conducted with the utmost secrecy.

The consideration paid by the Union National Bank to the Marquette National Bank for the latter's business, assets, and property was $75,000 for the bank building, fixtures, and real estate, $5,000 for bank furniture, the assumption by the Union National Bank of the liabilities of the Marquette National Bank to its depositors and other creditors, and a balance in cash. Tangible assets, other than the bank building, furniture, fixtures, and lot, were taken at their face value. Nothing was paid for the "goodwill" of the Marquette National Bank. Plaintiffs concede that full value was paid for the assets and property so sold and transferred, except as to two items—the bank building, together with the lot upon which it is located, and the "goodwill" appertaining and belonging to the business.

(1) *Value of Bank Building, Fixtures, and Lot.*—Plaintiffs contend that, at the time of the transfer on the 6th day of October, 1921, the fair value of the bank building and lot was approximately $150,000 . . .

On the 6th day of October, 1921, before the Union National Bank took formal possession, one of the plaintiffs made a written offer of $150,000 in cash for the property, coupled with an agreement to permit the Marquette National Bank to occupy the bank

offices, rent free, during the period required for the liquidation of its assets. This offer was rejected by defendants, for no other apparent reason than that its acceptance would have interfered with their plan to take the property for themselves. At the hearing of this case and during his cross-examination by defendants' counsel, the same plaintiff offered to pay $100,000 for this property. . . . A careful review and examination of the evidence upon this subject compels the conclusion that the bank building, fixtures, and lot, which were conveyed to the Union National Bank for the sum of $75,000 were fairly worth, at the time of such conveyance, at least the sum of $100,000.

(2) *Goodwill.*—However difficult it may be to define accurately and to determine with exactness what is included in the "goodwill" ordinarily incident to the sale and purchase of a business, in the situation and under the conditions presented by this record, it cannot be successfully denied that the "goodwill" of the business of the Marquette National Bank which was appropriated by the other defendants was of large value. It is idle to contend that a successful and prosperous banking business of 20 years' growth, possessing and enjoying the full confidence of its patrons and the general public, housed in suitable and well-equipped banking offices in a choice location, having deposits of upwards of $2,000,000, all invested in gilt-edge securities bearing a high rate of interest, earning from 15 to 20% per annum upon the capital invested therein, and paying large dividends to its stockholders, has no "goodwill" which it can sell and convey to the purchaser of all of its assets and property. Indeed, it is conceded that the Union National Bank by its purchase derived large benefits of substantial value over and above the consideration paid for the tangible assets and property of the Marquette National Bank. But defendants advance the anomalous contention that although in the purchase and sale of the bank property and business the purchaser could and did acquire a valuable asset of "goodwill," yet the seller had no "goodwill" of value to sell.

The argument to sustain this contention is twofold: First, that the "goodwill" connected with the business of the Marquette National Bank, if any existed, was not owned by the bank, but pertained and attached to the management, and belonged to the managers, and could be held or disposed of by them for their own personal advantage and benefit; second, that upon the expiration

of the bank's charter its business as a banking institution ceased to exist, and hence that all "goodwill" incidental thereto also ceased to exist. The fallacy of the argument lies in the fact that neither premise is true. In this case the managers of the business were either the agents or the trustees of the bank and its stockholders, and everything of value resulting from their services and efforts as such agents or trustees belonged, not to them individually, but to their principals or *cestuis que trustent,* the bank and its owners. The insistence that the business of the Marquette National Bank ceased to exist upon the expiration of the bank's charter is likewise without merit. In fact, through the manipulation and management of the individual defendants, the business of the Marquette National Bank was appropriated and continued, without the slightest interruption or loss, in every respect and detail, except the change of name, and even such change was so cleverly and adroitly managed, represented, and advertised that neither the general public nor the patrons and customers of the bank realized that it was anything more than a technical legal requirement connected with the renewal of the bank's charter. In this manner, the Union National Bank, without effort or expense on its part, was enabled to open its doors on the morning of the first day of its active existence in possession of a highly prosperous and successful business of 20 years' growth and standing. Having thus appropriated and converted to their own use the "goodwill" of the Marquette National Bank, so created and built up by and through a large expenditure of time and money, defendants cannot escape liability for the full value thereof, if such value can be ascertained and determined.

The success, earnings, and profits of a bank depend almost wholly upon its deposits. Hence the size and amount of such deposits furnish a fairly accurate index to and measure of the value of the "goodwill" which goes with a sale and transfer of its business to another bank. The testimony of the witnesses in this case upon the question of the value of a bank's "goodwill," as measured by and based upon the amount of its deposits is widely divergent, ranging from a maximum of 5% to 8% of such deposits in banks located in large cities like New York and Chicago, to a minimum of 1% or 2% of the deposits in banks located in small cities like Marquette. Without discussing the testimony in detail, we may safely conclude that, computed upon this basis, the fair value of the "goodwill" of the Marquette National Bank

transferred to and acquired by the Union National Bank was 3½% of the deposits, so obtained and retained by the latter bank, or the sum of $73,780.

Again, if the difference between the book value and the market value of the shares of the bank's capital stock immediately prior to the sale and transfer be accepted and applied as a measure of value of "goodwill," substantially the same result will be obtained.

If the question be considered from the standpoint of earnings; or of expense in obtaining deposits, a substantially different result does not follow.

. . . .

6. *The Decree.*

. . . .

(3) Appointing a receiver for the Marquette National Bank, to take charge of its remaining assets and to continue and complete the liquidation of such bank and its business and assets.

(4) Setting aside the appointment of the Union National Bank, as liquidating agent of the Marquette National Bank, and requiring the Union National Bank to render an account of its doings, and of all moneys and property which have come into its hands as such liquidating agent, and to pay and turn over to the receiver of the Marquette National Bank all moneys and property now in its possession or under its control and belonging to the Marquette National Bank.

(5) Ordering, directing, and requiring the individual defendants and the Union National Bank forthwith to pay to such receiver the additional sum of $25,000 for the bank building, lot, furniture, and fixtures, and the sum of $73,780 for the "goodwill" of the Marquette National Bank and its business, or a total amount of $98,780, together with interest thereon at the rate of 5% per annum from the 6th day of October, 1921, to the date of the decree herein.

Plaintiffs will recover their costs of suit, to be taxed against the Union National Bank and the individual defendants.

What method was used for valuing the deposits?

At what rate did the court capitalize the earnings of the bank?

What were and what are the prevailing rates upon capital invested in banking and other industries?

MARLOW NATIONAL BANK

VALUATION OF CONTROLLING STOCK FOR PURCHASE[1]

The Marlow National Bank had approximately 30 stockholders, but the president and the members of his family owned 650 of a total of 1,250 shares. The president was 76 years of age, and, since there was no one in his family able to assume his place in the supervision of the bank, he decided to dispose of the stock and to invest the proceeds otherwise. Accordingly, in the spring of 1930, the president offered the 650 controlling shares to the vice president, who was the executive head of large business interests in that part of the state.

The Marlow National Bank had been organized in 1906 and was located in Marlow, an Indiana city of approximately 8,000 inhabitants. There were two commercial banks, two savings banks, and one building and loan association in the city. The Marlow National Bank and its competitor had deposits and resources of approximately the same amount. Neither bank operated a savings department. Relations between the two were friendly, and the officers of the banks cooperated fully, even to the extent of joint advertising.

The principal industry of the section of the state in which the city of Marlow was located was bituminous coal mining. Until 1921 the coal industry had been prosperous, and this condition had been reflected in the deposits and profits of the Marlow National Bank. From the business depression of 1921 until the spring of 1927, the coal industry of the state, which operated under a wage agreement with the United Mine Workers of America, suffered from the competition of the nonunion fields of Kentucky and West Virginia. These latter fields had a lower scale of wages. The unsatisfactory condition of the coal industry affected all the business of the community. In the spring of

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[1] References for use with this and subsequent cases involving valuation of banks: Djörup, Christian, "Valuation of Bank Stock in Consolidations," *Proceedings of Departmental Conferences*, American Institute of Banking, June, 1930, pp. 91–100; Badger and Guthmann, *Investment Principles and Practices*, Ch. IV, and pp. 577–588; Guthmann, H. G., *The Analysis of Financial Statements*, Ch. XVII. For another case, see Ebersole, J. F., *Bank Management—A Case Book*, first edition, Lake City State Bank.

1927 the existing wage agreement between the miners' union and the coal operators, known as the Jacksonville Scale, expired, and, because of the failure of the parties to agree to a new wage basis, a general strike occurred, and the mines were shut down. Operations were begun again on a nonunion basis in the fall of 1928.

The other major source of economic strength in Marlow was an important university, having about 200 faculty members and 2,500 students. The university had shown steady growth over a period of years. Those persons familiar with the situation in Marlow believed that this educational institution was the city's most valuable asset. Also there were several manufacturing enterprises in the city, two of which required bank lines exceeding the legal limits of the banks in Marlow.

The Marlow National Bank was chiefly a commercial bank, but in 1923 a trust department had been organized, and the bank acted as trustee, guardian, administrator, executor, receiver, and in similar fiduciary capacities. Although the bank did not receive savings deposits, at various times it secured deposits of public funds on which interest was paid. Substantial deposits of local state banks and of savings and loan associations also were held from time to time. A separate department was maintained for student checking accounts. The bank handled a considerable volume of collection items and sold a substantial number of travelers' checks. A service charge of 50 cents a month was made on checking accounts for which the average monthly balance fell below $50. This charge was installed in 1928 and had increased gross income by about $150 a month. The adoption of the service charge had eliminated a number of small accounts, without reducing the amount of deposits. The bank also rented safe deposit boxes to its customers at rates varying with size. The bank did not maintain a security-selling department but handled a considerable volume of security purchases for its customers, for which service a small commission was charged.

The bank was housed in a modern bank building, located at the intersection of the principal business streets of the city. This building was erected in 1920 at a cost of approximately $92,000. In 1922 a substantial charge-off was made, and the building account on the bank's books was reduced to $40,000.

The board of directors of the bank consisted of seven members and the officers, who were a president, vice president,

cashier, and assistant cashier. The assistant cashier also acted in the capacity of trust officer. The president and the vice president were not employed in the bank. Besides the cashier and the assistant cashier, there were four tellers and seven other employees.

In addition to the reserve account required to be maintained with the Federal reserve bank, the bank had correspondent accounts with banks in New York, Chicago, St. Louis, Cincinnati, and Indianapolis. A low rate of interest was obtained on these accounts.

Exhibit 1 shows the statement of resources and liabilities of the bank, as of December 31, 1929. An analysis of the loans and discounts on that date showed that $26,177 was past due, and of this amount $19,403 was good paper only temporarily past due, $5,045 was considered slow but collectible, $1,559 doubtful, and $170 worthless. Among the loans and discounts there was $25,300 of paper not yet due, which the officials of the bank considered doubtful, and $29,300 which they believed good but slow. As a result of the drastic reduction in security prices in the fall of 1929, it was found that a few collateral loans were insufficiently secured, but, with the exception of three small loans, the various

EXHIBIT 1

Statement of Resources and Liabilities, as of December 31, 1929

Resources		
Loans and Discounts	$ 811,960	
Overdrafts	26	
United States Government Securities	103,200	
Other Bonds and Securities	396,262	
Banking House	40,000	
Furniture and Fixtures	31,611	
Reserve with Federal Reserve Bank	79,364	
Cash and Due from Banks	238,368	
Cash Items	2,163	
Redemption Fund with United States Treasury	4,000	
Securities Borrowed	27,300	
Total Resources		$1,734,254
Liabilities		
Capital Stock	$ 125,000	
Surplus	125,000	
Undivided Profits	120,544	
Circulation Outstanding	80,000	
Deposits	1,103,151	
Bills Payable and Rediscounts	153,259	
Securities Borrowed	27,300	
Total Liabilities		$1,734,254

borrowers on these collateral loans were known to possess sufficient other resources to make the loans good. A classification of the bank's loans and discounts by amounts is given in Exhibit 2. The situation indicated was known to be general among banks in smaller communities. The bank's loans and discounts were made to business men in the city and to a limited number of farmers in the surrounding agricultural area. No loans were made outside of the city and the adjacent area which the bank served. In practically every case the bank obtained financial statements at least once a year from its borrowers, and many of its large borrowers submitted statements more frequently. On December 31, 1929, 36% of the bank's loans and discounts bore 7% interest, and the remainder, 6%. No loans were made at a rate lower than 6%, as this was the prevailing rate on commercial bank loans in Marlow.

EXHIBIT 2

Classification of Loans and Discounts, as of December 31, 1929

Number of Borrowers	Size of Loans	Amount	Per Cent of Number	Per Cent of Amount
139	$200 and under	$ 14,615	34.9	1.8
84	$ 201 to $ 500	29,231	21.1	3.6
37	501 to 1,000	25,983	9.3	3.2
37	1,001 to 2,000	60,085	9.3	7.4
54	2,001 to 5,000	178,621	13.6	22.0
29	5,001 to 10,000	196,494	7.3	24.2
10	10,001 to 15,000	128,290	2.5	15.8
8	15,001 to 25,000	178,641	2.0	22.0
398		$811,960	100.0	100.0

In addition to $103,200 of United States Government securities owned, the bank had borrowed $27,300 of similar bonds. Of this total of $130,500, $80,000 was deposited with the United States Treasury to secure national-bank note circulation. Included in the other bonds and securities, amounting to $396,262, were $51,544 of municipal bonds, $51,569 of foreign bonds, $40,788 of railroad bonds, $55,473 of public utility bonds, and $196,888 of industrial bonds and miscellaneous securities. The securities were carried on

the bank's books at cost if purchased at a discount, and at par if acquired at par or at a premium. When the market prices of bonds declined, the book values of many of the bank's holdings had been written down to correspond with prevailing market values, so that the figures given on the bank's statement probably understated the current market value of the securities. Excluding United States Government and municipal bonds, the bank obtained a yield of 6.02% on the total cost price of securities owned on December 31, 1929.

Exhibit 3 shows the changes in capital, surplus, undivided profits, and total resources from 1920 to 1929, inclusive. The capital of the bank originally consisted of 1,000 shares of $100 par value, and, in 1922, 250 additional shares were sold to the stockholders. In 1921 the surplus account was increased from $20,000 to $50,000, and in 1924 to $125,000. Of the $125,000 in the surplus account on December 31, 1929, $25,000 had been paid in by the shareholders, and the remaining $100,000 had been set aside from undivided profits. In the 10-year period the total invested capital had grown from $192,006 to $370,544. In Exhibit 4 are shown the deposits of the bank, as of December 31, for the years 1920 to 1929, inclusive. In 1920 the coal industry in Indiana was at the height of its prosperity, and the depression which followed was reflected in the gradual decline in the deposits of the bank.

EXHIBIT 3

Capital, Surplus, Undivided Profits, and Total Resources, as of December 31, 1920 to 1929*

Year	Capital	Surplus	Undivided Profits	Total Invested Capital	Total Resources
1920	$100,000	$ 20,000	$ 72,006	$192,006	$2,167,573
1921	100,000	50,000	64,413	214,413	1,653,329
1922	125,000	50,000	103,116	278,116	1,800,412
1923	125,000	125,000	49,163	299,163	2,220,221
1924	125,000	125,000	65,102	315,102	2,019,942
1925	125,000	125,000	78,808	328,808	1,939,091
1926	125,000	125,000	82,941	332,941	1,841,176
1927	125,000	125,000	87,306	337,306	1,868,083
1928	125,000	125,000	105,932	355,932	1,714,637
1929	125,000	125,000	120,544	370,544	1,734,254

* The data contained in Exhibits 3 to 8, inclusive, have been reproduced as taken from the books of the bank, but not verified.

EXHIBIT 4

Deposits, as of December 31, 1920 to 1929

Year	Demand Deposits	Postal Savings Deposits	United States Government Deposits	Deposits of Other Banks	Total Deposits
1920	$1,726,206	$20,957	$59,000	$ 23,304	$1,829,467
1921	1,244,002	8,668	50,000	34,246	1,336,916
1922	1,202,835	8,769	40,000	58,142	1,309,746
1923	1,698,827	5,998	5,483	30,459	1,740,767
1924	1,342,505	9,813	......	47,454	1,399,772
1925	1,259,709	10,179	3,820	64,876	1,338,584
1926	1,081,533	9,546	3,840	68,321	1,163,240
1927	1,038,154	10,955	......	125,636	1,174,745
1928	1,004,154	3,269	......	69,587	1,077,010
1929	993,860	5,259	......	104,032	1,103,151

Exhibit 5 shows the gross earnings of the bank from loans, discounts and investments, exchange and collection charges, trust department, and other sources. In many of the years, the bank made substantial profits on its bond investments, which are included in the classification of other income. Profits from this source in 1928 were $16,758, and in 1929, $14,226. Exhibit 6 shows the expenses of the bank for the years 1920 to 1929, during which period a marked increase occurred in salary expense. Although a few employees were added, the increase was caused in large part by more liberal compensation to the bank's existing personnel. Interest and discount on borrowed money fluctuated with the volume of funds secured from the Federal reserve bank and the

EXHIBIT 5

Classification of Earnings, 1920 to 1929

Year	Income on Loans, Discounts and Investments	Exchange and Collection Charges	Trust Department Income	Other Income	Total Gross Income
1920	$ 81,008	$2,294	......	$ 7,523	$ 90,825
1921	96,622	1,806	......	8,781	107,209
1922	82,363	1,339	......	8,377	92,079
1923	104,117	1,949	$ 150	3,350	109,566
1924	107,236	1,195	1,872	1,113	111,416
1925	96,284	958	1,681	3,517	102,440
1926	92,764	1,053	730	17,037	111,584
1927	90,505	842	547	8,720	100,614
1928	88,492	785	2,330	19,000	110,607
1929	81,495	576	1,764	17,806	101,641

correspondent banks. Variation in interest on deposits was caused by fluctuations in the amount of public funds on deposit in the bank. Taxes, in this exhibit, include Federal income, state, county, and local taxes paid by the bank.

EXHIBIT 6

Expenses, 1920 to 1929

Year	Salaries and Wages	Interest and Discount on Borrowed Money	Interest on Deposits	Taxes	Other Expenses	Total Expenses
1920	$16,988	....	$16,877	$ 4,165	$11,705	$49,735
1921	18,692	$ 151	18,957	5,299	15,195	58,294
1922	18,887	2,615	8,869	8,238	12,154	50,763
1923	24,217	1,852	17,777	8,993	18,011	70,850
1924	26,541	4,593	19,212	9,965	11,406	71,717
1925	26,711	7,208	15,759	11,077	11,207	71,962
1926	24,730	4,720	14,167	10,109	13,006	66,732
1927	26,764	5,192	10,287	11,697	12,321	66,261
1928	29,975	12,320	9,855	9,409	12,461	74,020
1929	27,499	6,083	8,023	9,008	12,413	63,026

Exhibit 7 shows the losses and depreciation charged off and the recoveries from charge-offs in each year during the period. In 1924 the effects of the depression in the coal industry began to be felt severely, and the bank's losses on loans and discounts thereafter were somewhat larger. The substantial depreciation charge made against the bank building in 1922 is disclosed in this exhibit. Exhibit 8 summarizes Exhibits 5, 6, and 7, and indicates the net earnings available for dividends each year.

EXHIBIT 7

Losses and Depreciation Charged Off, and Recoveries on Charged-off Loans and Securities, 1920 to 1929

Year	Losses on Loans and Discounts	Losses on Bonds and Securities	Other Charge-offs	Total Charge-offs	Recoveries
1920	$ 2,436	$13,851	....	$16,287	$ 1,355
1921	8,900	7,745	....	16,645	6,550
1922	....	1,901	$51,774	53,675	27,785
1923	5	1,646	7,112	8,763	8,627
1924	5,350	2,240	9,938	17,528	13,768
1925	6,175	197	317	6,689	4,916
1926	21,467	4,044	748	26,259	542
1927	14,664	2,385	441	17,490	2,503
1928	4,945	13,724	630	19,299	16,340
1929	864	8,236	194	9,294	290

EXHIBIT 8

Earnings, Expenses, Dividends, and Additions to Undivided Profits, 1920 to 1929

Year	(a) Gross Earnings	(b) Recoveries	(c) Total (a + b)	(d) Expenses	(e) Losses and Depreciation	(f) Total (d + e)	(g) Net Earnings (c − f)	(h) Dividends Paid	(i) Net Additions to Undivided Profits (g − h)
1920	$ 90,825	$ 1,355	$ 92,180	$ 49,735	$ 16,287	$ 66,022	$ 26,158	$ 6,000	$ 20,158
1921	107,209	6,550	113,759	58,294	16,645	74,939	38,820	6,000	32,820
1922	92,079	27,785	119,864	50,763	53,675	104,438	15,426	6,750	8,676
1923	109,566	8,627	118,193	70,850	8,763	79,613	38,580	12,500	26,080
1924	111,416	13,768	125,184	71,717	17,528	89,245	35,939	20,000	15,939
1925	102,440	4,916	107,356	71,962	6,689	78,651	28,705	15,000	13,705
1926	111,584	542	112,126	66,732	26,259	92,991	19,135	15,000	4,135
1927	100,614	2,503	103,117	66,261	17,490	83,751	19,366	15,000	4,366
1928	110,607	16,340	126,947	74,020	19,299	93,319	33,628	15,000	18,628
1929	101,641	290	101,931	63,026	9,294	72,320	29,611	15,000	14,611
Totals.......	$1,037,981	$82,676	$1,120,657	$643,360	$191,929	$835,289	$285,368	$126,250	$159,118
Average.....	103,798	8,268	112,066	64,336	19,192	83,529	28,537	12,650	15,912

EXHIBIT 9

Figures for Selected New York Banks, Based on December 31, 1929, Statements*

	Total Deposits (000 omitted)	Total Deposits per Share	Book Value per Share	Price per Share (March 13, 1930)	Earned per Share	Price Earnings Ratio	Per Cent Earned on Total Assets	Current Dividends	Current Yield	Ratio of Deposits to Capital Funds†
Bank of America, N. A.	$ 305,905	$ 213	$ 52§	$ 132	$ 5.30‖	24.9	1.55	$ 4.50¶	3.41 %	4.11
Bank of N. Y. & Trust	126,960	2,116	338	770	36.22	21.3	1.34	20.00**	2.60	6.26
Bankers Trust...... ..	606,217	242	43	157	5.10	30.8	1.56	3.00	1.91	5.63
Brooklyn Trust.......	122,437	1,530	381	830	31.55††	26.3	1.59	30.00**	3.62	4.02
Chase National.......	2,073,645‖‖	280	65‡‡	178	6.08‖	29.3	1.37	4.00	2.25	5.17
Chatham Phenix......	239,186	295	54‡‡	128	5.50‖	23.3	1.18	4.00	3.12	6.71
Commercial National	101,767	1,453	255‡‡	585	27.00††	21.7	1.86	....	. ..	6.44
Corn Exchange.. .. .	263,717	435	57	225	6.31	‡	1.28	4.00	1.78	7.60
Empire Trust.	90,032	300	51	84	4.67§§	18.0	1.33	3.00††	3.57	5.88
First National.........	408,781	4,087	1,134§	5,675	206.75	27.5	3.64	100.00	1.76	3.61
Harriman National¶¶	50,252	2,512	264‡‡	1,400	30 00¶¶	46.6	.97	35.00¶	2.50	10.05
Guaranty Trust	1,309,290	1,454	325	780	16.91***	‡	1.15	20.00	2.57	4.47
Irving Trust.	660,373	132	27	62	2.61‖	23.7	1.32	1.60	2.58	4.94
National City.........	1,649,554†††	299	44§	239	5.78***	41.4	1.47	4.00	1 68	6.88
New York Trust......	305,103	610	94	285	11.68‖	24.4	1.42	5.00	1.76	6.52
Public National Bank & Trust........ ..	166,786	505	73§	140	8.56‖	16.4	1.22	4.00	2 86	6.87

* Source: Standard Statistics Company, Trade and Securities Service, Industries Section, Vol. 55, No. 69, *New York City Bank Stocks,* March, 1930, except Total Deposits per Share, which has been computed from data in this source.

† Includes capital, surplus, and undivided profits.
‡ Not accurately determinable.
§ Does not include figures of or equity in Securities Company.
‖ On average shares.
¶ Includes dividends paid by Securities Company.
** Includes extras.
†† Indicated.
‡‡ Includes Securities Company.
§§ On new stock.
‖‖ After merger with Equitable and Interstate Trust.
¶¶ After 33⅓ % stock dividend.
*** Six months ending December 31.
††† Excluding figures of the City Bank Farmers Trust Company and the National City Company.

EXHIBIT 10

Figures for Selected Indiana Banks, Based on December 31, 1929, Statements*

Bank	Total Deposits (000 omitted)	Total Deposits per Share	Book Value per Share	Bid Price or Range, per Share	Dividend per Share	Yield†	Ratio of Deposits to Capital Funds‡
1	$ 916	$ 916.00	$266.54	$ 300	§	....	3.44
2	1,027	513.50	134.03	135	$ 6.00	4.44	3.52
3	1,345	672.50	145.99	145–150	8.00	5.42	5.02
4	1,453	415.00	143.15	225	12.00	5.33	2.90
5	1,629	814 50	126.70	110	6.00	5.45	6.43
6	1,795	718.00	123.88	88–100	4.00	4.26	5.80
7	1,920	960.00	127.21	110–115	§	....	7.55
8	1,938	1,292.00	232.43	228–230	10.00	4.37	5.27
9	1,976	988.00	186.59	200	6.00	3.00	5.29
10	2,322	774.00	192 55	275	10.00	3.64	4.02
11	2,419	803.00	196.31	250	10.00	4.00	4.11
12	2,426	808.70	176.95	185	9.00	4.86	4.57
13	2,489	1,659.30	229.48	250–260	14 00	5.49	7.23
14	2,892	723.00	125.65	200	8.00	4.00	5.75
15	3,035	758.80	196.64	250	10 00	4.00	6.17
16	3,403	3,403.00	163.20	170–200	8.00	4.32	4.17

* Source: *Moody's Manual of Investments, Banks and Finance*, 1930; compiled from individual statements.
† Figured on average price.
‡ Includes Capital, Surplus, and Undivided Profits.
§ Not reported.

The vice president to whom the controlling interest in the Marlow National Bank was offered decided to purchase, provided that the stock could be secured at a fair price. When negotiations began, however, it was discovered that the president placed a considerably higher value on the shares than the vice president believed them to be worth. There had been only one sale of the stock in 1929, but the lot sold had been small, and the transaction had been between two members of the same family. The president of the bank used price figures for banks in New York City to show that the price he asked for his stock was fair, whereas the vice president introduced price figures for Indiana banks to support his contention that the asked price was excessive. Both the president and the vice president discounted the value of published figures for averaged earnings and expenses of a large number of banks as irrelevant in valuing a specific Indiana bank.[1] Exhibits 9 and 10 present figures for New York and Indiana banks, respectively.

[1] Several of the Federal reserve banks, notably the Federal Reserve Banks of Boston and New York, have made studies of the income and expenses of the member banks in their respective districts, and the results of these studies are published annually. For the earnings and expenses of all member banks, see *Federal Reserve Bulletin*, July, 1930, pp. 411–413; for national banks, see *Annual Reports of the Comptroller of the Currency*. For figures and a discussion of bank income and expenses, consult Jamison, C. L., *Management of Unit Banks*, Michigan Business Studies, Vol. III, No. 2, pp. 254–268. Consult also Secrist, Horace, *Banking Ratios*.

What adjustments should be made in the items appearing in the balance sheet in order to determine liquidating value?

What adjustments should be made in the income and expense items in order to determine net earnings?

How should bond account profits be treated in estimating past and prospective earnings?

Should earning power be judged by: (*a*) earnings of the last full year, (*b*) average earnings for a fixed number of years, or (*c*) trend of earnings statistically calculated?

In estimating past and prospective earnings and asset values, how much weight should be given to: (*a*) ability and/or experience of the controlling management, (*b*) ability and/or experience of the prospective management, (*c*) growth of the community, and (*d*) stage of the business cycle?

Estimate the prospects for growth or decline in the economic activity of Marlow and vicinity.

What is the relative "bargaining power" of the buyer and seller in this case? Does bargaining power determine the value of bank stock?

What ratios are useful in estimating the value of a bank's stock? Are there standard ratios? If so, how do these ratios in the Marlow National Bank case compare with standard ratios?

Enumerate the various methods by which the value of the stock of a bank may be determined. How can these methods be applied in this case?

What was the lowest price the seller might reasonably be expected to insist upon? The highest price the buyer might reasonably be expected to pay? Does controlling stock have a value per share different from "minority" stock?

What price should have been paid per share for the controlling stock in this case?

NORTHERN NATIONAL BANK

CONSOLIDATION FORCED BY A BANK RUN[1]

After the closing of the thirtieth largest bank in the United States,[2] located in New York City, in the middle of December, 1930, bank failures and rumors of bank failures were numerous throughout the country. By January, the general unrest, coupled with considerable local gossip to the effect that the Southern State Bank, located in an Indiana city of about 35,000 population, would have to close, started a gradual withdrawal of deposits from this institution. The silent run did not develop into a panicky rush at the door because the officers of the Southern State Bank assured a selected few of the larger depositors that, if necessary, the institution would be taken over by the Northern National Bank. Credence was given to this statement because the Northern National Bank had taken over another local bank a few years earlier.

During the week ending January 3, the deposits of the Southern State Bank fell from over $3,400,000 to $2,400,000. To meet

[1] For references containing discussion and data on bank consolidations, consult: Anderson, B. M., Jr., "Bank Consolidations in a Period of Speculation," *The Chase Economic Bulletin*, October 12, 1929; Mumford, G. S., "The Concentration of Banking Resources," *Harvard Business Review*, January, 1930, pp. 137–146; Lawrence, J. S., *Banking Concentration in the United States: A Critical Analysis;* Sykes, Joseph, *The Amalgamation Movement in English Banking, 1825–1924; Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Sixty-ninth Congress, first session, on S. 1782 and H. R. 2* (February, 1926); *Annual Report of the Federal Reserve Board*, 1929, pp. 29–31; *ibid.*, 1930, pp. 21–22.

For the law and administrative rulings on consolidation, see: National Bank Act, Ch. V, §§503–505; *Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks*, Ch. IX, or *Digest of Rulings of the Federal Reserve Board* (1914–1927, inclusive), pp. 498–516. For the law regarding the effect of consolidation upon trusts at the time of this case, see Regulations of the Federal Reserve Board, Regulation F, *Annual Report of the Federal Reserve Board*, 1930, pp. 245–250. For a more recent form of Regulation F, see Regulations of the Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, May, 1936, pp. 327–336; January, 1938, pp. 10–13; December, 1939, p. 1054; June, 1940, pp. 502–509.

Bank consolidations are not always brought about by distress conditions. The principles of valuation for voluntary mergers are the same as for banks in difficulty, but the bargaining power of the respective parties and the significance of liquidating value in the negotiations are somewhat different.

[2] See case of Bank of United States, *infra*. The designation "thirtieth largest" is based upon the called report figures of September 24, 1930. On the calls of December 30, 1929, and June 30, 1930, it was the "twenty-eighth largest."

these withdrawals and those of earlier weeks, the Southern State Bank had utilized fully all readily salable assets, as well as its credit with its correspondent banks, and had practically exhausted its stock of till money. It was apparent to the officers of the bank that the silent run had not terminated, and that without further cash funds, they would be compelled to close the bank some time during the following Monday.

The officers of the Northern National Bank, located in the same city, upon learning of the withdrawals from the Southern State Bank, believed that it would probably close. In preparation for the effects of such closing upon their own position they acquired, as early as Thursday of the week ending January 3, and held in vault, about $650,000 in coin and currency.

A substantial stockholder in the Southern State Bank was informed regarding the situation, and he initiated a movement to arrange a consolidation of the Southern State Bank with the Northern National Bank, since the latter was the only other bank in the vicinity of sufficient size and strength to undertake such a merger. This stockholder was in control of a large local manufacturing plant and felt a certain amount of moral responsibility for the stability of the Southern State Bank, inasmuch as he and his associates had participated, to a considerable extent, in founding it, in recommending it continuously to prospective customers, and in exchanging favors with it. The officers and leading directors of the two banks held an overnight session, directing their efforts to the formulation of a plan for a possible consolidation.

In these preliminary negotiations the Northern National Bank agreed to assume the deposits and bills payable liabilities of the Southern State Bank, totaling $2,760,000, in exchange for a note of the Southern State Bank for a like sum, secured by a pledge of all the assets, including charged-off assets, owned by the Southern State Bank, but subject to inspection and rejection. The officers of the Northern National Bank thereupon made a careful examination of the assets that would need to be taken as security for the note.

The examination revealed mismanagement. The books and papers of the Southern State Bank were not in satisfactory order. Nearly every loan was incomplete, some lacking signatures to assignments of collateral, others the assignments themselves.

This deficiency was particularly true of loans secured by life insurance policies or by real estate mortgages. For the latter, even title papers and insurance were missing in many cases. The assets were found to contain a number of large loans made to officers and senior employees of the manufacturing company. These loans were of questionable value because they were unsecured and liquidatable only over a long period of time out of future salaries. In brief, the examination resulted in the rejection of $800,000 of assets as unsatisfactory and unacceptable. It was decided that the bank building listed in the assets of the Southern State Bank would be unsuitable for the purposes of the consolidated bank; and the opinion prevailed that, if the bank closed, the maximum realization by depositors would not exceed 50 cents on the dollar, because many of the assets were such as would be depreciated in value instantly upon the closing of the bank.

It was apparent that a consolidation could not be effected unless some way could be found in which to satisfy the officers of the Northern National Bank that the $800,000 of undesirable assets would be paid or removed. It was agreed by all the persons engaged in the negotiations that it would be a community calamity if the Southern State Bank closed its doors. Public confidence inevitably would be destroyed, runs on other banks would be started, the prestige of the city in surrounding territory would be impaired, and the known integrity of the parties who had sponsored the distressed bank would be questioned.

After prolonged and numerous conferences during the week-end, it was proposed that cash, guaranties, or other contributions of value be obtained from every party having an interest in keeping the bank open. The community spirit was strong enough to make this proposal a practical one. One of the interested parties, a corporation with substantial holdings of local real estate, agreed to buy the bank building and fixtures at their book value ($170,000). The Northern National Bank agreed to pay $90,000, or at the rate of 3¾%, for the goodwill value of the deposits of the Southern State Bank at the time of consolidation. The stockholders of the Southern State Bank agreed to pay in cash into an escrow fund, to be held by the Northern National Bank, the total amount of the statutory liability upon their stock ($150,000),

this fund to be released to the Southern State Bank at the end of one year, subject to a deduction for any deficiency then remaining unpaid upon the note to the Northern National Bank. The local manufacturing corporation, which had recommended the bank to its employees, and to the officers of which a total of $200,000 was then outstanding in questioned personal loans, agreed to pay in $350,000 in cash. The other clearing house banks in the city agreed to assess themselves 1% of their deposits and to pay this ($40,000) in cash, a sum sufficient with the other agreed payments to provide a total of $800,000, equal to the amount of the unacceptable assets.

Of the parties participating in this plan, the clearing house banks and the manufacturing corporation were given promissory notes of the Southern State Bank for their respective cash advances, such notes having a secondary lien or residual claim upon all the assets of the Southern State Bank, subject to the lien of the note given to the Northern National Bank. The Northern National Bank also agreed to assume all expenses of liquidating the assets of the Southern State Bank and to take over the entire personnel for a period of 90 days. In view of the poor management exposed, it was decided to give the four active officers of the Southern State Bank subordinate positions in the Northern National Bank, two of them with a term of office expiring at the end of 90 days, and the other two with a tenure of tentative character until experience should indicate their permanent usefulness.

As a final persuasive argument, the other banks in the local clearing house were assured of a right to share in the large vault reserve built up by the Northern National Bank according to their needs on or after the subsequent Monday, when the consolidation was to be announced to the public. The plan as adopted was submitted to and approved by the Comptroller of the Currency as to the Northern National Bank, and by the state supervisory officials as to the method of liquidating the Southern State Bank, and thereupon declared effective.

Analyze and criticize the consolidation agreement from the viewpoints of the several parties involved.

Name and appraise the alternatives probably available to the Southern State Bank.

16. BRANCH, GROUP, AND CHAIN BANKING

CHARLES NATIONAL BANK

ADMISSION OF A BANK TO A GROUP BANKING SYSTEM[1]

In the fall of 1930, the president of the Charles National Bank invited officials of the Young Bankshares Corporation to consider the advisability of acquiring the bank. The financial statements of the bank and of the corporation, covering operations before, during, and after the period of negotiation, are shown in Exhibits 1–6.

The corporation owned a group banking system sponsored by the Young Trust Company, a prominent metropolitan institution which had organized the group in 1929. By June 30, 1930, the corporation held stock controlling 17 banks.

The bank was located in a city of 150,000 inhabitants, 65 miles distant from the headquarters of the corporation. This city, which was a manufacturing center of some importance, surrounded by a rich agricultural district, was dominated by a long-established

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[1] Books: Anderson, T. J., Jr., *Federal and State Control of Banking*, Ch. VII; Cartinhour, G. T., *Branch, Group and Chain Banking;* Chapman, J. M., *Concentration of Banking;* Collins, C. W., *Rural Banking Reform;* Lawrence, J. S., *Banking Concentration in the United States;* Ostrolenk, Bernhard, *The Economics of Branch Banking;* Southworth, S. D., *Branch Banking in the United States;* Belloc, Hilaire, *The Restoration of Property*.

Shorter articles: Anderson, B. M., Jr., "Branch Banking throughout Federal Reserve Districts," *The Chase Economic Bulletin*, May 8, 1930; American Bankers Association, The Economic Policy Commission, *A Study of Group and Chain Banking;* Zimmerman, C. F., "For the Defense: the Unit Banker Defends Unit Banking," *Credit and Financial Management*, April, 1933, pp. 16ff.; *Hearings before the Committee on Banking and Currency, House of Representatives, Seventy-first Congress, second session, under H. Res. 141; Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Seventy-first Congress, third session, pursuant to S. Res. 71;* Dowrie, G. W., "The Branch Banking Situation and Outlook," *Harvard Business Review*, Summer, 1938, pp. 411–423.

Statistics and official recommendations: *Federal Reserve Bulletin*, December, 1929, April and December, 1930, October, 1938, February, 1940; *Annual Reports of the Board of Governors of the Federal Reserve System*, especially 1939, pp. 53–54; *Annual Reports of the Comptroller of the Currency*, especially 1930, pp. 1–10; *Annual Reports of the Secretary of the Treasury*, especially 1932, pp. 30–32.

Laws: "Compilation of Federal and State Laws Relating to Branch Banking within the United States" (as of August 15, 1939), *Federal Reserve Bulletin*, October, 1939, pp. 851–870. See: Title 12, §§36, 52, 61, 161, 221(a), 321, 334, 336–338, 371(c), 481, and Title 15, §15, U.S.C., 1934 edition.

See Appendix VI for sample solutions of this case.

EXHIBIT 1

Semiannual Income Statements of the Charles National Bank, June 30, 1930, to June 30, 1931

	June 30, 1930			December 31, 1930			June 30, 1931		
Interest Received from Loans	$309,246			$265,514			$219,010		
Interest Received from Investments	58,406			53,487			62,173		
Interest Received from Banks	10,933			14,947			14,301		
Total Interest Received		$378,585			$333,948			$295,484	
Exchange		16,408			17,232			12,428	
Service Charges		4,320			5,624			5,555	
Profit on Securities Sold		400			......			....	
Trust Department Income		3,621			13,580			6,016	
Safe Deposit Box Rentals		7,085			} 5,897			} 9,282	
Miscellaneous Earnings		1,233							
Gross Earnings			$411,652			$376,281			$328,765
Interest Paid on Demand Deposits	$ 41,878			$ 40,236			$ 32,216		
Interest Paid on Bank Deposits	18,086			15,873			15,263		
Interest Paid on Time Deposits	75,367			79,997			69,822		
Interest Paid on Borrowed Money	10,939			78			107		
Total Interest Paid		$146,270			$136,184			$117,408	
Salaries		109,321			109,213			101,142	
Other Expenses		66,118			52,175			62,876	
Accrued Taxes		29,756			10,029			17,312	
Total Interest, Expenses, and Taxes			351,465			307,601			298,738
Net Earnings			$ 60,187			$ 68,680			$ 30,027
Net Losses and Charge-offs			5,421			76,616			5,460*
Net Earnings after Losses			$ 54,766			$ 7,936(d)			$ 35,487
Dividends			40,000			40,000			40,000
Net Earnings after Dividends			$ 14,766			$ 47,936(d)			$ 4,513(d)
Transferred to Reserves			....			... ...			31,281
Transferred from Reserves			14,935			....			....
Net Additions to Profits			$ 29,701			$ 47,936(d)			$ 35,794(d)

* Recoveries.
(d) Deficit.

EXHIBIT 2

Quarterly Income Statements of the Charles National Bank, March 31 and June 30, 1931

	March 31, 1931			June 30, 1931		
Interest Received from Loans	$111,437			$107,573		
Interest Received from Investments	28,882			33,291		
Interest Received from Banks	8,744			5,557		
Total Interest Received		$149,063			$146,421	
Exchange		6,002			6,426	
Service Charges		....			5,555	
Profit on Securities Sold		....			....	
Trust Department Income		2,376			5,640	
Safe Deposit Box Rentals / Miscellaneous Earnings		} 5,866			} 3,416	
Gross Earnings			$163,307			$165,458
Interest Paid on Demand Deposits	$ 16,864			$ 15,352		
Interest Paid on Bank Deposits	7,930			7,333		
Interest Paid on Time Deposits	40,260			29,562		
Interest Paid on Borrowed Money	....			107		
Total Interest Paid		$ 65,054			$ 52,354	
Salaries		54,731			46,411	
Other Expenses		30,188			32,688	
Accrued Taxes		9,863			7,449	
Total Interest, Expenses, and Taxes			159,836			138,902
Net Earnings			$ 3,471			$ 26,556
Net Losses and Charge-offs			8,348			13,808*
Net Earnings after Losses			$ 4,877(d)			$ 40,364
Dividends			20,000			20,000
Net Earnings after Dividends			$ 24,877(d)			$ 20,364
Transferred to Reserves			....			31,281
Transferred from Reserves			....			....
Net Additions to Profits			$ 24,877(d)			$ 10,917(d)

* Recoveries.
(d) Deficit.

bank having deposits in excess of $40,000,000. The Charles National Bank, with nearly $15,000,000 of deposits, had two competitors of about its own size. It had grown rapidly in the years prior to 1930 and had become the second largest bank in the community. The corporation had no member in the bank's immediate vicinity. Officials of the corporation had confidence in the growth of the surrounding territory, and agreed to send representatives to examine the bank with a view to making an offer for its stock.

Whenever the corporation became interested in acquiring a bank, it conducted a preliminary survey covering the following points: the earning power of the bank, the condition of the assets, the nature of the deposits, the prospects for the development of new business, and the adequacy of personnel. If such a general examination proved satisfactory, a complete audit was made to determine the exact condition of the bank and the basis on which an exchange of stock might be effected.

After examining the bank concerning the points mentioned, the representatives of the corporation returned a report, containing the following information:

1. *Earning Power.*—For several years prior to 1930, interest received by the bank, less interest paid by it, had shown a return of over 3% per annum on total deposits.[1] In the first six months of 1930, with rates relatively low, interest received less interest paid totaled $232,315, equivalent to 1.59% on deposits of $14,610,170, or an annual rate of 3.18%. Furthermore, the situation of the bank in regard to both interest received and interest paid was somewhat unusual. In an attempt to build up its volume of business, the bank charged rates which, in many cases, appeared lower than the quality of the risk would ordinarily dictate. For the same reason, the bank was liberal in paying interest. Nearly 74% of its accounts were on an interest-bearing basis, and a number of these accounts were not entitled to receive interest under the regulations of the local clearing house association. Consequently, it appeared that the return from interest could be increased considerably and that the bank had a large potential earning capacity.

[1] It was usually possible to increase the income and decrease the expenses of a bank after admission to a group banking system. However, such improvements nearly always were effected in the minor items of income and expense. Rates of interest received and interest paid, on the other hand, were largely predetermined by local conditions. Consequently, the corporation felt that if interest received, less interest paid by a prospective member, did not show a gross return of about 3% on deposits, the bank in question was not likely to prove a desirable addition to the group.

The net earnings record of the bank was found to be rather poor, although the stock had been placed on an 8% dividend basis in January, 1929. The corporation believed that under group management a country bank ordinarily should show net earnings from all sources equivalent to approximately 1½% a year on total deposits. In the first half of 1930, the bank reported net before losses and charge-offs of $60,187, equal to .41 of 1% on deposits of $14,610,170, or an annual rate of .82 of 1%. In seeking reasons for these low net earnings, it was discovered that the bank was overofficered and that the item of officers' salaries was inordinately high. Two contributing factors were the large percentage of unprofitable deposit accounts without compensating service charges and the mediocre average yield on bonds and securities, which showed a gross return at the rate of 3.77% per annum in the first six months of 1930. The liberal dividend policy of the bank and a 100% increase in its capital stock, which took place in 1927 and involved no addition to paid-in surplus, accounted for the comparatively low book value of $131.56 for each $100 par value share on June 30, 1930.

2. *Asset Condition.*—The loans and discounts of the bank were not of the first quality. This criticism was due not so much to the intrinsic soundness of the risks involved as to the size of the loans and lines of credit extended. In an attempt to get business away from the largest competing bank in its city, the Charles National Bank had resorted to rate cutting and the granting of accommodation in excessive amounts. Although losses had not been serious for a number of years, it was expected that some difficulty would be encountered as a result of the depressed business conditions prevailing in the fall of 1930.

The investment portfolio of the bank was open to criticism in several particulars. The bank virtually had no commercial paper or short-term corporation bonds suitable for secondary reserve purposes. This deficiency was made up by large amounts in deposits with banks and in United States Government securities. However, the yield on these assets was small and declining. The item, Other Bonds and Securities, which appeared at $429,371 on the June 30, 1930, statement, was made up largely of second-grade issues which showed a sizable amount of depreciation from the figures at which they were carried on the bank's books.

3. *Deposit Liabilities and New Business Prospects.*—The average size of the deposit accounts in the bank was small and the number of transactions handled was large in relation to total deposits. Here again there was evidence of the manner in which the bank had handled the competitive situation. The new business department had been aggressive, but had stressed volume at the expense of securing quality accounts.

It appeared that the business extension activities of the bank would be more effective and would involve less cost if attention were focused on a smaller number of more desirable prospects. Such a program would make it possible to eliminate certain officers who concerned

themselves more with getting new business than with internal administration.

EXHIBIT 3

Statements of Condition of the Charles National Bank, as of June 30 and December 31, 1930, and June 30, 1931

	June 30, 1930	December 31, 1930	June 30, 1931
Resources			
Cash and Due from Banks	$ 3,259,234	$ 4,255,116	$ 2,732,807
United States Bonds and Securities	2,670,440	2,284,659	1,633,649
Other Bonds and Securities	429,371	944,849	1,786,508
Loans and Discounts	9,851,655	9,060,287	8,548,980
Accrued Interest Receivable	19,978	21,261	40,191
Redemption Fund	20,000	20,000	20,000
Customers' Liability on Acceptances	102,417	16,480	11,745
Real Estate, Furniture, and Fixtures	183,235	161,694	154,286
Total	$16,536,330	$16,764,346	$14,928,166
Liabilities			
Capital	$ 1,000,000	$ 1,000,000	$ 1,000,000
Surplus	200,000	200,000	200,000
Undivided Profits	115,657	67,721	31,927
Reserves	56,802	56,802	88,083
Demand Deposits	9,969,479	10,142,107	9,402,116
Time Deposits	4,640,691	4,840,307	3,743,216
Unearned Discount	51,284	40,929	51,081
Circulation	400,000	400,000	400,000
Acceptance Liability	102,417	16,480	11,743
Total	$16,536,330	$16,764,346	$14,928,166

4. *Personnel.*—The officers and employees of the bank were as capable as could be found in banks of the same size. However, a total of 97 employees and 13 officers for an institution with deposits of $14,600,000 was considered excessive. Unnecessary personnel and overlapping of responsibility needed correcting.

On the basis of this preliminary information, the officials of the corporation concluded that it would be unwise to acquire the bank unless terms of exchange could be arranged that would be distinctly favorable to the corporation. At the same time, these officials felt that the bank possessed the foundation for a profitable business and that, with careful supervision, it would be possible to improve the affairs of the bank.

The corporation, for which balance sheets and an income statement are shown in Exhibits 4, 5, and 6, aimed to make exchanges for the stock of unit banks on such a basis that each exchange

would increase the earning power and book value behind its own shares. It was necessary also to obtain a considerably larger return from holdings of the stock of members than the amount which the corporation paid out in the form of dividends. The book value behind each share of $20 par stock in the corporation on June 30, 1930, was $13.19, arrived at by adding the resources of the corporation, exclusive of stock in affiliates, and 95% of the capital, surplus, and undivided profits of the affiliated banks, and dividing by the number of shares of the corporation's stock outstanding. The dividends paid by the corporation amounted to 60 cents a share per annum. Consequently, on November 10, 1930, the officials of the corporation made a tentative offer of nine shares of corporation stock for each share of bank stock, which would give the corporation $131.56 of book value in return for $118.71, and $8 in dividends in return for $5.40. The market price of corporation stock at the time of this offer was 12¼; a sale of bank stock had been made shortly before at 120. This offer was subject to change or withdrawal after receipt of the bank's income account and statement of condition, as of December 31, 1930, or in the event that the auditing department of the corporation made an adverse report after examining the bank in detail.

EXHIBIT 4

Balance Sheets of the Young Bankshares Corporation, as of June 30 and December 31, 1930

	June 30, 1930	December 31, 1930
Assets		
Cash and Short-term Investments	$ 1,823,309	$ 1,751,902
Bonds	1,102,835	740,620
Notes Receivable	1,693,140	1,616,610
Accounts Receivable	55,845	71,114
Accrued Interest Receivable	....	33,491
Stock of Affiliates	34,900,640	36,003,700
Total	$39,575,769	$40,217,437
Liabilities		
Capital Stock	$34,071,920	$34,664,820
Surplus	4,989,425	5,023,874
Reserves	514,424	522,192
Accounts Payable	....	700
Unearned Discount	....	5,851
Total	$39,575,769	$40,217,437

EXHIBIT 5

Consolidated Statement of Condition of the Young Bankshares Corporation Group, as of June 30 and December 31, 1930

	June 30, 1930	December 31, 1930
Assets		
Cash and Due from Banks	$ 34,146,502	$ 37,962,051
United States Bonds and Securities	16,874,814	16,604,310
Other Bonds and Securities	30,957,375	34,418,520
Loans and Discounts	94,130,225	92,952,592
Redemption Funds	135,953	152,865
Reserves with Federal Reserve Bank	8,204,079	8,186,398
Customers' Liability on Acceptances	1,247,352	419,755
Banking Houses and Real Estate	4,484,042	4,490,416
Other Assets	1,140,171	1,424,135
Total	$191,320,513	$196,611,042
Liabilities		
Capital	$ 10,140,000	$ 10,500,000
Surplus	5,574,000	5,743,000
Undivided Profits	3,021,437	3,050,445
Reserves	1,225,049	1,469,335
Deposits	165,613,477	170,820,072
Circulation	2,414,590	2,458,190
Acceptance Liability	1,247,352	419,755
Bills Payable	1,205,787	1,218,043
Other Liabilities	878,821	932,202
Total	$191,320,513	$196,611,042

EXHIBIT 6

Consolidated Income Statement of the Young Bankshares Corporation Group for the 12 Months Ending December 31, 1930

Interest Received	$9,063,340	
Other Income	1,897,853	
Gross Earnings		$10,961,193
Interest Paid	$3,434,278	
Operating Expense	4,091,473	
Taxes	612,938	
Expenses		8,138,689
Net Operating Income		$ 2,822,504
Losses and Charge-offs		467,300
Net Income after Losses		$ 2,355,204
Portion of Net Income after Losses Applicable to Stock Held by the Corporation (94.76%)		$ 2,231,791*

* Equivalent to $1.29 a share on 1,733,241 shares of corporation stock, as compared with $1.50 a share on 1,675,151 shares in 1929.

On the basis of this tentative offer, the bank agreed to permit an examination of its books by the corporation's auditors. The examination was completed on December 15, 1930. The principal results and recommendations of this audit were as follows:

1. Approximately $76,500 should be written off before the closing of the books on December 31, 1930, to take care of bad loans and losses in the investment account.

2. Of the loans and discounts of the bank, $1,993,000 were classed as slow or doubtful, and some provision should be made to cover this item in the event that the corporation decided to make an exchange for the stock of the bank.

3. Approximately $1,000,000 of the holdings of government obligations on June 30, 1930, ultimately should be liquidated and applied to the purchase of diversified secondary reserve assets. Miscellaneous bonds having a par value of $155,000, charge-offs on which were included in the $76,500 of losses mentioned above, should be sold. Funds realized from any decrease in loans and discounts and from a recommended reduction in deposits with banks should be placed in sound investment bonds.

4. The internal efficiency of the bank, as reflected in Exhibit 7, should be increased.

EXHIBIT 7

Efficiency Tests of the Charles National Bank.
Based on Operations for January to June, 1930, and Comparison of Results with Four Banks in the Young Bankshares Corporation Group.

	Bank	Position Relative to Four Banks of the Group Having Capital of $500,000 to $1,000,000
Annual Officers' Salaries per $1,000,000 of Deposits	$ 6,331	Highest
Annual Total Salaries per $1,000,000 of Deposits	$ 14,935	Highest
Deposits per Officer	$1,125,947	Lowest
Deposits per Employee	$ 150,126	Lowest
Number of Accounts per Officer	1,019	Lowest
Number of Accounts per Employee	136	Lowest
Number of Items Handled per Employee per Month	3,658	One Lower
Number of Items Handled per Bookkeeper per Month	13,516	One Lower
Bookkeeping Cost per Item	$0.0062	One Higher
Transit Cost per Item	$0.0065	Two Higher

This report, and the receipt of the income account and statement of condition of the bank for December 31, 1930, led the

corporation to revise its offer for the stock of the bank. Early in January, 1931, the corporation definitely proposed an exchange on the basis of eight shares of its own stock for each share of bank stock. The corporation made the added stipulation that in the event that the exchange should be effected 15,000 shares of its own stock be placed in trust by the former stockholders of the bank as a guarantee against losses on slow and doubtful loans. These shares, amounting to $300,000 par value and $196,875 at the market on January 15, 1931, were to be sold in such quantities as might be needed to reimburse the bank for losses taken during the first six months of 1931.

On this basis, the corporation secured 9,650 of the 10,000 outstanding shares of the bank. The remaining stock represented directors' qualifying shares and two blocks held by persons who did not wish to make the exchange.

After acquiring the stock of the bank, the corporation placed one of its executives in the bank to supervise the making of necessary changes. Comparatively few lines of credit were discontinued, but many were reduced, and renewals of loans, in a majority of cases, were accepted only for smaller amounts. The credit manager was replaced by a more competent man who was promoted from within the department, and a discount committee, made up of the ablest officers of the bank and with its duties carefully defined, was organized. The bond account of the bank was turned over to the statistical department of the corporation for a thorough analysis, and a number of desirable changes were made. The rate of interest paid on savings deposits was reduced from 3½% to 3%. Many checking accounts were taken off an interest basis and, in some instances, the rate charged on loans was increased. An entirely new system of deposit account analysis was installed in the bank, and service charges were enforced. Some loss in deposits resulted, but the business lost appeared to have been largely unprofitable. The personnel of the new business department was considerably reduced, and the facilities of the corporation and its other member banks were made available in the securing and investigating of prospects. More definite authority was given to department heads throughout the bank, and the internal organization of several departments was improved. Important reductions in salary were put into effect among the officers, 14 officers and employees were dismissed, and some others were transferred to positions in other banks in the group. The

auditing department of the corporation made frequent examinations of the bank and watched with great care the trend in its affairs.

Exhibits 1, 2, and 3 show the progress which was made in the bank during the first half of 1931. In addition to these tangible evidences of improvement, the corporation felt certain that it had saved the bank from serious losses and that the changes and economies which it had instituted would show more definite results after they had been in effect for a greater length of time and after general business conditions improved.

POWELL TRUST COMPANY

OPENING OF A BRANCH OFFICE

The Powell Trust Company of San Francisco had an extensive branch system with offices throughout the San Francisco Bay region. With the exception of a few of the larger branches in San Francisco itself and in the downtown sections of Oakland and Berkeley, the bank's offices were located in suburban business centers and were designed principally to obtain and handle individual checking and savings accounts. Because of the class of business which the trust company sought through its branches, the establishment of new offices necessarily followed lines of residential growth. In 1924 the branch control department of the bank had undertaken, with the assistance of outside real estate consultants, to map out the probable future trends in suburban development around San Francisco Bay. This survey had resulted in the selection of several localities which gave promise for the future and in which banking facilities were lacking or inadequate to care for the expected development. The growth of these localities was watched closely. Traffic counts on rapid transit lines, telephone company statistics, and similar data were used to supplement the branch control department's own appraisal of the progress which was being made toward the point at which the establishment of branches in these vicinities would be profitable.

The opening of a new office was seldom considered by the branch control department unless investigation had shown that such an office should be able to obtain $1,000,000 in deposits in a year's time. Although conditions varied widely between branches, an office having this volume of deposits, employing eight or ten persons, and paying $5,000 or $6,000 a year in rent, ordinarily could be operated on a profitable basis.[1] It was hoped that

[1] Almost every branch of the trust company had a large excess of deposits over and above the amount of loans made by the branch manager. This surplus was loaned or invested at the head office and each branch was credited monthly with the gross earning rate for the institution as a whole on the amount of loanable funds contributed.

branches would show a direct profit from operations within 12 months after they were established. However, differences in the type of accounts handled and in business and money market conditions prevailing at the time an office was opened were so great that this was not regarded as an absolute necessity.

When the branch control department decided that a locality was capable of producing a satisfactory volume of deposits, its next step was to employ a real estate dealer to negotiate for a location. This dealer was instructed to find out the prices at which desirable sites in the neighborhood could be purchased and the rental which would be charged for space in buildings not for sale. In some cases, he was authorized to secure an option to buy on a particularly good site. These preliminaries in regard to banking quarters were important for two reasons. In the first place, a proper location was essential to the success of a new office. Secondly, it had been the experience of the trust company that the profitability of a branch usually bore a close inverse relationship to the amount of rental charged against it. Thus, with the rental which would have to be paid known in advance, final determination of the advisability of opening a branch was simplified considerably.

The trust company purchased the premises occupied by most of its suburban branches. The chief argument against leased quarters was the difficulty of resisting increases in rental. Once a vault and fixtures had been installed, moving became expensive. Furthermore, it was often impossible to find another near by location which fitted the requirements for a branch office. In a few cases, the bank had constructed new buildings to accommodate branches. Usually, however, existing store buildings were purchased and remodeled. Where a branch occupied its own building, it paid all maintenance costs and, in addition, was charged a rental fee by the head office. This fee gave the bank a 6% return on its investment in the building, and also provided for depreciation at the rate of 4% per annum, or complete amortization in 25 years. Occasionally, larger buildings than were required for the accommodation of a branch had been purchased. In such cases, the branch had receipts from tenants to help defray its own rental cost.

After a definite location for a proposed branch office had been chosen, the vice president in charge of the branch control department submitted a report to the executive committee at the head

office. This report set forth the reasons for the selection of a locality and the volume of deposits which could be expected within a reasonable time. It also described the site and the capital investment necessary to acquire it. Attached to this report were a schedule of installation costs and a budget of probable monthly operating expenses. If the establishing of the new office was approved by the executive committee, a letter was written to the state banking department applying for a permit to open the branch.[1] A bank examiner was sent to inspect the locality and formal approval to commence operations was given or withheld on the basis of his recommendation. The trust company never had been denied permission to open an office.

On May 4, 1931, the trust company opened a new branch, which it called the Bay Farm office, in a growing community southeast of Oakland. This vicinity, which was served by the Southern Pacific Railroad and rapid transit and bus lines, was becoming increasingly popular for middle-class residences. Although it required somewhat more than an hour to reach San Francisco from the particular locality chosen for the branch, moderate rentals and land prices had been attracting a growing number of office workers who were employed in that city, as well as persons engaged in business on the Oakland side of the bay. In spite of the populous residential district which was within easy reach of the new office, there was only one other bank near by. This was due to the existence of a more important shopping and business center two and one-half miles distant. This latter center, which had been an independent community before it was enveloped by suburban growth, contained three banks.

The Bay Farm office occupied a two-story frame and stucco building on the principal street of the community in which it was located. The entire building was utilized, the second floor being devoted to lavatories for the employees and extra working and storage space. The total cost of acquiring this site and remodeling the interior of the building to meet the needs of the branch was $70,000. The location was a good one, two doors from the corner of one of the town's most important cross streets and within a block of the sites which had been chosen by three well-known chain store organizations. The Bay Farm office was some distance away from the other local bank, which was situated on a side street three blocks from the main thoroughfare.

[1] See *Bank Act of the State of California*, Sec. 9.

During the first 11 months after the Bay Farm office was opened, it operated at a loss, chiefly because of the low earning rate which the head office was realizing on loanable funds and was crediting to branches. In the month of April, 1932, however, the office showed a small profit. At the close of business on March 31, 1932, the branch had $1,035,000 in deposits, two-thirds of which were savings deposits. There were 810 deposit accounts on the books, and out of a total of 750 safe deposit boxes provided when the vault had been installed, 585 were rented. Local loans made by the manager were negligible in amount, $15,000 being outstanding on March 31. Twelve persons, including the manager, were employed on a full-time basis. In common with the other branches of the trust company, the Bay Farm office had paid 3% interest on savings deposits during the 12 months ended April 30, 1932. A service charge of $1 a month was made for the handling of checking accounts which maintained a balance of less than $100.

The branch control department was well satisfied with the results shown by the Bay Farm office. The $1,035,000 in deposits was entirely new business, since the trust company had no other branch within five miles.[1] In view of the low earning rate which had been credited on deposits and the somewhat higher-than-average rental and payroll expenses which the Bay Farm office bore, the placing of operations on a profitable basis in less than 12 months was unusual.

Between May 4, 1931, and March 31, 1932, the Bay Farm office showed a total net loss of $46,800. This loss included the 11 monthly operating deficits incurred and certain installation costs which were charged directly to the branch instead of being capitalized and written off over a period of years. The latter costs included publicity, the stationery and supplies originally provided, minor building expenses, and miscellaneous items. This net loss, applied to the $1,035,000 in deposits which the office had on the date that its operations became directly profitable, indicated a cost of 4½ cents per dollar of deposits. This figure, however, was misleading in that it did not take into account future benefits which would be derived from the original expenditure. To a greater or less extent, the receipt of every dollar of deposits which subsequently came into the Bay Farm office

[1] The apparent success of many new offices was due to the fact that they drew accounts away from existing branches.

would be a product of the expenses involved in establishing this office and making it known in the neighborhood. Consequently, the trust company felt that the $46,800 had been well invested, although it would not have paid a similar sum for the outright purchase of $1,035,000 in deposits from another bank on March 31, 1932.

Under what conditions, if any, might a metropolitan bank operate a branch office at a steady loss or at a subnormal profit?

In certain instances, branches of the trust company had opened with sufficient deposits to make operations immediately profitable. Why should not the establishing of new branches always be delayed until such a result is assured?

Why was the trust company satisfied with its investment in the Bay Farm office when it would have been unwilling to pay $116,800 for a unit bank having a building and location worth $70,000 and deposits of $1,035,000?

What items which contributed to the building up of the Bay Farm office's volume of deposits were not included in the $46,800 of expense?

LANIER SIXTH NATIONAL TRUST & SAVINGS BANK

CENTRALIZED VERSUS UNIT MANAGEMENT IN BRANCHES[1]

During the spring of 1929, the consolidation of the Lanier Trust & Savings Bank and the Sixth National Bank, two of the important banks in Los Angeles, California, was announced. Each of these institutions had a large number of branch offices, and, since the systems of branch control which they employed were diametrically opposed to one another in principle, the question of how this problem should be handled by the merged bank was an important one in the negotiations which took place prior to the consolidation.

In 1925 the Lanier Trust & Savings Bank had determined to undertake the active solicitation of small deposit accounts. The directors of the institution felt that a substantial volume of this type of business would be secured in the outlying residential parts of the city, if the bank could make itself accessible to the people living in these districts. Accordingly, they had entered upon a program of expansion through branches, with the ultimate object of establishing offices in all of the more important suburban business centers and at such points in the downtown section as would reach patronage that could not use the bank's main office.

Mr. Hovey, one of the senior vice presidents of the Lanier Trust & Savings Bank, administered the branch department, which had been organized to develop and maintain a system of branch control. It had been Mr. Hovey's opinion that the type of business which the branch offices were expected to develop would be relatively easy to obtain. Consequently, he had recommended that operations in the branches be as thoroughly standardized as possible, and that a system of rigid supervision from the main office be inaugurated, in order to reduce costs and losses to a minimum. In accordance with this policy, Mr. Hovey had worked out the following general rules for branch control:

[1] Krick, E. V., "Management and Accounting Control of Branch and Group Banks," *Bulletin*, American Institute of Banking, Vol. XIII, pp. 25–39 (January, 1931).

1. *Banking Quarters.*—Leased premises, if readily adaptable to the layout of a banking room, are to be preferred. The erection of buildings to house branches is not recommended.

Equipment installed in branch offices should be standard and as inexpensive as is consistent with good appearance.

2. *The Business of Branches.*—Commercial accounts, savings accounts, and safe deposit business will be handled in all branches. On scheduled dates, representatives of the bank's bond and trust departments will be present in all except the smallest branches to give advice and sell the bank's investment and trust services.

All cash not required for till money will be kept at the main office, and all checks on other banks will be collected and cleared through the central clearance department.

Branch managers will not be allowed to open new lines of unsecured credit on their own initiative, and will have power to exercise discretion only in making loans on approved credit lines or against certain previously specified types of stock exchange collateral with specified margins. They will, however, give the bank's answer to applicants for unsecured loans or lines of credit, in accordance with instructions received from the main office.

Branch managers and assistant managers will be required to devote at least three hours each day to the solicitation of new accounts in the district surrounding the office to which they are attached. The importance of this phase of their duties cannot be overemphasized.

All branch offices will remain open from 7:30 until 9:00 on Saturday evenings.

3. *Personnel.*—Branch managers and their assistants will be selected, as far as possible, from the employees at the main office. For the most part, they will be clerks who have shown sufficient ability and energy to justify a promotion, but for whom better positions are not available or tenable at the head office. The salaries of branch managers will range from $3,000 to $4,000 per annum.

Managers will have charge of the other employees in their offices, but these employees will be hired by the personnel department at the main office, and final decisions in regard to salaries, transfers, dismissals, etc., will be in the hands of the personnel department manager.

4. *Reports.*—The following reports will be required from all branch managers:

(*a*) Daily reports of applications for lines of credit and loans which it is not within the branch manager's power to grant. These applications are to be accompanied by the financial statement of the prospective borrower, other information bearing on the credit risk involved, and the branch manager's recommendation as to the action which should be taken.

(*b*) Daily reports of applications for increases in existing lines of credit. These applications are to be accompanied by a summary of the previous experience of the branch with the customer, and the branch manager's recommendation.

(*c*) Daily statements of condition.

(*d*) Daily reports of new loans made and credit lines increased, either on the branch manager's own authority or with the sanction of the discount committee at the main office, using forms, as shown in Exhibits 1 and 2.

EXHIBIT 1

Lanier Trust & Savings Bank, Daily Report of New Loans Made

Branch		Week Ending	
Date	Borrower	Amount	Collateral

EXHIBIT 2

Lanier Trust & Savings Bank, Daily Report of Lines Increased

Branch			Week Ending	
Date	Borrower	Amount of Increase	Total Line	Collateral

(*e*) Weekly reports of accounts opened and closed, sample forms for which are shown in Exhibit 3.

EXHIBIT 3

Lanier Trust & Savings Bank, Weekly Report of Accounts Opened

	Branch		Week Ending	
Name	Kind of Account	Address	Amount	Reason for Opening

Weekly Report of Accounts Closed

	Branch		Week Ending	
Name	Kind of Account	Address	Amount	Reason for Closing

(*f*) Weekly summaries of fluctuations in the number of accounts and of occurrences in the branch territory which are of interest from the point of view of developing new business. Items which branch managers are expected to report under the latter heading include the opening of new stores, progress being made by competing banks in the vicinity, etc. A sample form is shown in Exhibit 4

EXHIBIT 4

Lanier Trust & Savings Bank, Manager's Weekly Summary

Branch Week Ending

Number of Accounts Open Previous Week..............

Number of New Accounts............................

Number of Closed Accounts............................

Number of Accounts Open at Close of Week..............

Other Items of Interest..............................

(*g*) Monthly expense accounts, a sample form for which is shown in Exhibit 5.

EXHIBIT 5

Lanier Trust & Savings Bank, Monthly Expense Account

Branch Month of

Item	This Year	Last Year
Salaries	$	$
Printing, Stationery, and Supplies		
Telephone, Telegraph, and Express		
Repairs and Maintenance		
Equipment		
Furniture and Fixtures		
Advertising		
Postage		
Rent		
Tellers' Differences		
Losses		
Legal Fees		
Miscellaneous		
Total	$	$
Average due from Main Office	$	$
Average Time Deposits		
Average Demand Deposits		
Average Loans		

(*h*) Monthly summaries of branch activities, with particular regard for the showing made in the number of accounts and the volume of deposits. A sample form is shown in Exhibit 6.

EXHIBIT 6

Lanier Trust & Savings Bank, Manager's Monthly Summary

Branch Month of

Net Gain in Number of Accounts for Month..............
Net Gain in Number of Accounts for Year ....
Net Gain in Deposits for Month........................
Net Gain in Deposits for Year.........................
Present Number of Accounts............................
Total Deposits..
Other Items of Interest...............................

5. *Supervision of Branches.*—The vice president in charge of the branch department will make a personal call at each office, at least once a week, for purposes of inspection and discussion of problems facing the branch managers.

A meeting of all branch managers will be held every two weeks. Instructions regarding both general policies and routine matters will be issued to managers at these meetings.

The auditing department of the bank will make frequent inspections of the books of each branch.

By the end of 1928 the Lanier Trust & Savings Bank had established 18 branches. The policy of soliciting small accounts through these branch offices had apparently been justified, since, during the three years following its adoption, deposits of the bank as a whole had increased by more than 30%. The cost of this new business had been low, expenses which branch offices had incurred in securing deposits having averaged 2% of the dollar volume of these deposits. Other benefits which had accrued to the Lanier Trust & Savings Bank through its branches, but which officials of the bank considered of secondary importance to the large volume of deposits obtained, were an increased demand for loans and the advertising value of branches to the main office.

On December 31, 1928, the Sixth National Bank had 12 branch offices in the city and county of Los Angeles. This bank had begun to establish branches in the year 1918, but had proceeded slowly in its expansion program. The business of the Sixth National Bank was chiefly commercial, and for that reason the bank had not been particularly interested in increasing the number of its savings and small checking accounts. The directors had believed that the most profitable type of branches, in the long run, would be those which were able to supply business men in their vicinity with complete banking accommodations and to occupy an important place in the development of a community. In accordance with this policy, the Sixth National Bank had adopted the so-called unit system of branch control and had aimed to make its suburban offices as much like independent banks as possible, while still retaining certain of the economies of centralized management. It had been an invariable rule of the Sixth National Bank that it should own the buildings occupied by its branch offices, and, in several instances, it had erected buildings at considerable cost when appropriate quarters were not available.

Each branch office had officers who were authorized to act entirely on their own initiative. The clearing of checks drawn on other banks, however, had been handled at the main office.

All branch managers had held the rank of at least an assistant cashier, and two large downtown offices were in charge of vice presidents. Each manager had acted as the loaning officer of his branch, and each had been assigned a limit, determined by the size of the branch and the ability of the man, up to which he was empowered to lend or grant credit lines without consulting the credit committee at the main office. These limits had varied

from $5,000 in the two smallest and newest branches to $50,000 in the case of the branches managed by vice presidents. Credit folders for all the borrowing customers of a branch had been kept in its own files, even in cases where the accommodation extended was so large as to require the sanction of the credit committee before it was granted. Branch managers and assistant managers had been expected to develop new business in their districts, but had concentrated such activities on the large accounts in the vicinity. They had been urged to make their homes in the districts where they worked, join local clubs, take part in local enterprises, and attempt to become the friends and financial advisers of business men in the community. The salaries of branch managers had ranged from $6,000 to $12,000 a year. These men had been given a great deal of discretion in their dealings with the employees who were under them.

The only reports which the Sixth National Bank had required from its branches, aside from applications for loans or credit lines exceeding the loaning limit of the manager, were daily statements of condition, weekly summaries of loans granted on the manager's own authority, and weekly statements of accounts opened and closed.

Once each week one of the senior vice presidents of the bank had made an informal call on every branch manager. Managers had been encouraged to interview these officers or the president of the bank at any time. The auditor from the head office and his assistants had inspected the books of each branch from time to time, these audits being unannounced and in the nature of an ordinary bank examination.

The cost of the increase in deposits directly traceable to the branches of the Sixth National Bank had averaged about 4% of the dollar volume of these deposits. Many desirable borrowing accounts had been secured, however, even by the newest branches, and the prestige of certain of the better-established offices had grown to such a point that their profits, which were computed separately by the auditing department, actually were larger in relation to their deposits than were those of the main office.

During the negotiations preceding the consolidation of the Lanier Trust & Savings Bank and the Sixth National Bank, the representatives of each institution advanced arguments in favor of the adoption of the respective policies of branch control. The points stressed by the representatives of the Lanier Trust & Savings Bank may be summarized as follows:

1. The majority of suburban residents are not potential borrowing customers, but are potential depositors. These deposits are profitable and they should be actively solicited.

2. The cost of establishing and operating branches and of obtaining business is much lower under a system whereby the various banking functions are centralized at the main office and branch managers are not paid large salaries.

3. A better class of credit risks results when borrowing customers are investigated by a larger staff providing greater specialization.

4. Uniform policies with regard to the extension of credit and other functions of the bank are obtainable only under a system of centralized control.

5. The personnel problem, particularly in regard to obtaining suitable branch managers, is greatly simplified, and the risk of loss through the dishonesty of managers and other employees is lessened when rigid supervision of operations is exercised and complete information regarding branches is available at all times.

The representatives of the Sixth National Bank supported its unit system by the following arguments:

1. It has been demonstrated that large deposit and borrowing accounts are obtainable in suburban districts, and it is a well-known fact that this business is far more profitable than that of a large number of small accounts.

2. Few companies or individuals wish to deal with a mere automaton in their relations with a bank. Consequently, in order to secure profitable accounts, branch managers must be given initiative and must have a friendly interest in their customers.

3. Different clienteles have different credit needs and should be judged by different credit standards. A branch manager who knows his customers is better able than others to select the good risks, and he will attract such risks.

4. It is uneconomical to have the central credit department and the senior loaning officers spend time on small borrowers.

5. Under a system of decentralized control, branches are an invaluable training school for future senior officers.

6. A bank cannot take full advantage of the development of a district unless the branch located therein is regarded, essentially, as a local institution which is interested in, and intimately bound up with, the welfare of the community.

Evaluate public opinion, suitable personnel, centralization to avoid overhead costs, and long-run profitability as influences to be considered. What other factors, if any, should be considered in making the decision?

Which system of branch control should have been adopted by the consolidated Lanier Sixth National Trust & Savings Bank?

17. SEEKING NEW CUSTOMERS

MANVILLE NATIONAL BANK

METHODS OF SECURING NEW BUSINESS[1]

The Manville National Bank, with capital and surplus in excess of $4,000,000 and deposits of $22,500,000, as of December 31, 1928, was the largest bank in an eastern manufacturing city of 200,000 inhabitants. It offered a complete banking service to its customers through the following departments: commercial, loan, savings, safe deposit, time deposit, collection, trust, foreign, coupon, and bond. The business of the bank was primarily commercial in character, although its trust business was increasing in importance, and the number of its savings accounts was large.

The organization of the new business department of the Manville National Bank was extremely simple. Development of new business was supervised by Mr. Boyd, one of the bank's four vice presidents. Under him were two younger men, Mr. Spencer and Mr. Hedges, who were not officers of the bank, and who combined their new business activities with credit work. Besides the solicitation done by Messrs. Spencer, Hedges, and Boyd, the latter enlisted the aid of all the other officers and the directors of the bank in securing new accounts.

In February, 1929, the president of the bank died and was succeeded by Mr. Tarbell, a former vice president of one of the large New York City banks. The new president was interested in the aggressive solicitation of new business and suggested to Mr. Boyd that substantial results would probably come from more work of this kind in the Manville National Bank. He called attention to the fact that, in spite of the bank's position as the largest and oldest institution of its kind in the local territory, its ratio of

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[1] References for use with this and subsequent cases dealing with the problems of obtaining new accounts: MacGregor, T. D., *The New Business Department*, third edition; Knapp, G. P., *How Banks Increase Their Business*, especially pp 65–76 and Ch. XII; Morehouse, W. R., *Bank Deposit Building*, especially Ch. VI; American Bankers Association, *Commercial Bank Management Booklet No. 14, New Business for Banks*. For other cases see: Milburn National Bank and Charlton Trust Company, Ebersole, J. F., *op. cit.*, first edition, pp. 414–418, 428–431.

deposits to capital and surplus[1] was lower than that of most of its competitors. Consequently, he requested that a special study be made of all new accounts secured during the ensuing three months, a report of their history and the methods employed in bringing them in to be submitted to him. He believed that a survey of this kind would show that the bank had been neglecting certain devices altogether, and that others had not been fully developed.

A selection of typical accounts, illustrating the various ways in which new business was obtained by the Manville National Bank during the period covered by the survey, follows:

1. *Mrs. Elizabeth Lacey.*—On April 2, 1929, Mrs. Elizabeth Lacey inquired of the guide in the lobby of the Manville National Bank where she could open a savings account. She was conducted to the savings department, where she stated that she had a checking account at the bank and wished also to open a savings

EXHIBIT 1

Manville National Bank, Central Information File Card

Name *Norman, V. A.*				Individual Account	
Department	Account Opened	Account Closed	Remarks	Woman's Acc't	Man's Acc't *X*
1. Commercial.......	*9/8/28*			Married *X*	
2. Savings......				Children *2*	
3. Time Deposit.....				Single	
4. Loan.............					
5. Collection...... ..					
6. Safe Deposit......				Remarks	
7. Trust............					
8. Foreign.					
9. Coupon..........					
10. Bond...					

Introduced by *Prof. Henry Mathews (our account)* Cross Reference
Accounts in Other Banks *None*
Occupation *Teacher* Position *Professor*
Business Address *4 University Hall*
City
Home Address *776 Elm Street*
City

[1] A rough working rule in regard to this ratio is that more than 10 to 1 indicates a low margin of safety for depositors, while less than 5 to 1 shows too small a volume of business for the profitable utilization of the capital invested. On this point, see case of Timberlake National Bank, *infra*.

EXHIBIT 2

Manville National Bank, Prospect Card

Name Norman, V. A. Address 4 University Hall, City

4/5/29. First call on prospect, suggested from central file card Mr. Norman is about 35 years of age, an assistant professor in English. He is married and has two young daughters. This is his first year at the University, but he likes his work and expects to stay. We talked about the services which the bank could offer, and I believe the trust department is the most likely. Mr. Norman handles his own investments, buying mostly through salesmen of Keating & Company. I called this pleasant interview to the attention of Mr. Carver in the trust department.

—R. Hedges.

4/11/29. At Mr. Carver's request, I called on Mr. Norman today to suggest that he stop at Carver's desk the next time he is in the bank. Norman seemed to appreciate the bank's interest and said he would be glad to talk to one of our trust officers about providing for his family.

—R. Hedges.

4/20/29. Mr. V. A. Norman stopped by to see me today. His income doesn't appear to be sufficient to talk trust funds yet, but he is interested.

—G. O. Carver.

6/17/29. Mr. Norman came in, and we had a long talk about the bank's trust service. I finally closed with him to make us executor under his will. Also think we might be able to secure an investment management account from him as he doesn't seem very well satisfied with some of the securities he has bought from Keating.

—G. O. Carver.

EXHIBIT 3

Manville National Bank, Central Information File Card

Name *Leary, Joseph, Jr.*		Account Closed	Remarks	Individual Account	
Department	Account Opened			Woman's Account	Man's Account *X*
1. Commercial	*3/7/27*			Married *X*	
2. Savings				Children	
3. Time Deposit				Single	
4. Loan	*1/13/28*	*7/13/28*	*Against stocks*		
5. Collection					
6. Safe Deposit				Remarks	
7. Trust				*Loan against stock exchange collateral 2/7/29 (6 months' note)*	
8. Foreign					
9. Coupon					
10. Bond					

Introduced by

Accounts in Other Banks *None*

Occupation *Manufacturer* Position *Vice President*

Business Address *Leary Manufacturing Company Centerville*

Home Address *143 Maple Street City*

Cross Reference

account, with an initial deposit of $50. This account had not been solicited.

2. *V. A. Norman.*—In studying the records of all customers, contained in the central information file of the Manville National Bank, Mr. Hedges' attention was drawn to the card shown in Exhibit 1.

The information recorded on this card suggested to Mr. Hedges that Mr. Norman might well be interested in several other departments of the bank. However, before making a personal call on him, Mr. Hedges looked up the balance in Mr. Norman's checking account which, on April 4, 1929, amounted to $825.

The prospect card filled out by Mr. Hedges and reproduced in Exhibit 2 is self-explanatory.

3. *Leary Manufacturing Company.*—The central file and prospect cards shown in Exhibits 3 to 5, inclusive, trace the progress made on an account which Mr. Spencer had been soliciting for some time in a near-by town.

EXHIBIT 4

Manville National Bank, Cross Reference Card

Name Leary Manufacturing Company. Address Centerville
Reference Leary, Joseph, Jr., Vice President

EXHIBIT 5

Manville National Bank, Prospect Card

Name Leary Manufacturing Company. Address Centerville
Pipe-fitting tools and plumbers' supplies

7/19/27. Cross reference from Joseph Leary, Jr., Vice President. Have checked on this company with credit department (see their folder) and was authorized to offer $25,000 unsecured credit. Also submitted name to directors' meeting, 7/15/27, and Mr. Kane thinks that his brother's concern, J. S. Kane & Company of New York, buys from Leary. No personal connection with this firm through our officers or board.

—W. Spencer.

7/22/27. First call on prospect company. Plant has good appearance, but there does not seem to be room for much expansion in present quarters.

Saw Joseph Leary, Jr., first. He doesn't seem to have much to say in the company's affairs, in spite of his office, and is apparently just being trained by his father. He introduced me to Mr. Darrell, Treasurer, who was pleasant, but did not seem interested in doing business with us. He tells me that the First National of Centerville takes care of their entire borrowing requirements and that he sees no immediate future need for another connection. Darrell also mentioned that he was solicited by the Merchants Trust, City, last year.

I invited Mr. Joseph Leary, Jr., to see me the next time he came into the bank.

—W. Spencer.

EXHIBIT 5. (*Continued*)

7/29/27. Mr. Kane phoned to say that J. S. Kane & Company is a customer of the Leary Company. He will do what he can on Leary through his brother, Mr. J. S. Kane.
—T. S. Boyd.

9/23/27. Mr. Joseph Leary, Jr., came in today. I asked him what he would think of my calling on the company again, and he said he couldn't see any use in it because his father is pretty closely tied up with the First National of Centerville. I introduced him to Mr. Boyd.
—W. Spencer.

10/14/27. Mr. Kane tells me that he has met Mr. Leary, Sr., personally and has spoken to him of this bank and of his son's connection with it. Mr. Leary remarked that his son is doing nicely in the company and is being given more responsibility all the time.
—T. S. Boyd.

1/13/28. I gave Joseph Leary, Jr., a loan against some common stocks today. He seems to be pleased with his connection here and said he was considering closing out his checking account in Centerville and giving us all his personal business.
—T. S. Boyd.

3/19/28. Mr. Leary, Jr., confirmed the report (see credit folder) that his father's company is going to build a new plant in the near future and said that he thought this expansion would afford us a good opportunity to get some of its business.

I spoke to Kane and Spencer about this.
—T. S. Boyd.

3/22/28. Called on Mr. Leary, Jr., today and made it a point to speak to Mr. Darrell while I was at the plant. I gave the latter a copy of the bank's new booklet on Federal Income Taxes.
—W. Spencer.

4/20/28. Called on Mr. Darrell and talked about their breaking ground for the new plant.
—W. Spencer.

8/11/28. Talked at some length with Mr. Darrell about what the company's borrowing requirements will be when they get their plant completed. He mentioned that both Mr. Leary and Mr. Leary, Jr., had spoken of us, and I think matters are improving considerably from our point of view.

Mr. Kane seems to have succeeded in influencing Mr. Leary, Sr., pretty definitely in our favor.
—W. Spencer.

11/1/28. Mr. Kane had Mr. Joseph Leary, Sr., in town for lunch today and asked me along to meet him.
—T. S. Boyd.

11/20/28. Mr. Boyd and I called on Mr. Leary, Sr., and Mr. Darrell today.
—W. Spencer.

2/6/29. Mr. Leary, Jr., asked Spencer and me to come out and look over the company's new plant today. His father went along and we had a very pleasant visit.
—T. S. Boyd.

3/18/29. Mr. Leary, Jr., brought his father into the bank today at my request. I introduced them to Mr. Tarbell, and we had luncheon together. We shouldn't let this contact get cold now as things are going very nicely.
—T. S. Boyd.

4/2/29. Mr. Leary, Jr., saw me today and said that the Leary Company has finally decided to open an account with us and that Spencer and I should call on his father and Darrell this week.
—T. S. Boyd.

4/5/29. Spencer and I closed with the Leary Company for a borrowing account amounting to $35,000 against the company's straight note. Darrell will make the initial deposit tomorrow.
—T. S. Boyd.

4. *McMorrow & Company.*—It was the opinion of the Manville National Bank that improvement of unprofitable accounts was an important form of new business development. Consequently, the task of inducing individual customers to increase their balances or reduce the activity of their accounts or their float of uncollected checks fell chiefly to Mr. Spencer and Mr. Hedges. When the account of a corporate borrower was unprofitable, the officer who had made the loan was expected to see that the situation was remedied.

In May, 1929, Mr. Cartwright, one of the vice presidents of the Manville National Bank, noticed that the showing made on McMorrow & Company's balance card (Exhibit 6) was less satisfactory during the early months of 1929 than it had been in 1928. Since Mr. Cartwright handled this account, he wished to know whether or not it was becoming actually unprofitable, and requested that an analysis sheet, shown in Exhibit 7, be prepared for his inspection.

EXHIBIT 6

Manville National Bank, Balance Card

Name *McMorrow & Company* Interest Authorized by
Address *17 Pine St., City* *None* *C. F. Cartwright*

1928					1929			
Foreign Acceptances	Secured Loan	Unsecured Loan	Average Net Balance	Month	Foreign Acceptances	Secured Loan	Unsecured Loan	Average Net Balance
		$14,000	*$2,300*	Jan.			*$12,800*	*$2,500*
		17,500	*2,900*	Feb.			*19,300*	*2,600*
		17,700	*3,000*	March			*20,000*	*3,100*
		20,000	*3,700*	April			*20,000*	*2,800*
		18,400	*3,700*	May				
		16,000	*2,100*	June				
		13,200	*2,000*	July				
		13,000	*2,000*	Aug.				
		14,500	*2,000*	Sept.				
		15,600	*3,200*	Oct.				
		15,400	*3,300*	Nov.				
		2,700	*3,300*	Dec.				
		$14,800	*$2,800*	Average				

Before deciding what action to take, Mr. Cartwright also looked up the ledger balances of McMorrow & Company. He saw that the company did not have a large number of uncollected checks outstanding, and that the activity of its account, while high, was not excessive. Therefore, he decided that the poor showing made on the analysis sheet was due merely to the fact

EXHIBIT 7

Manville National Bank, Analysis of Account

Name *McMorrow & Company* Address *17 Pine Street, City*	Interest *None*	Requested by *C. F. Cartwright*

	January, 1929	February, 1929	March, 1929	April, 1929
Gross Income	*$9.17*	*$9.53*	*$11.37*	*$10.27*
Less Interest	.....	.....	......	......
Gross Profit	*$9.17*	*$9.53*	*$11.37*	*$10.27*
Less Activity Cost	*7.43*	*6.82*	*8.03*	*8.91*
Net Profit	*$1.74*	*$2.71*	*$ 3.34*	*$ 1.36*
Expected Profit 1¼%*	*2.29*	*2.38*	*2.84*	*2.57*
Deficiency below 1¼%	*$ .55*	.....	......	*$ 1.21*
Excess above 1¼%	.....	*$ .33*	*$ .50*	......

Analysis Made *5/12/29*
Remarks

* The expected profit of 1¼ % was the result of a study made by the clearing house association in the city where the Manville National Bank was located, and of the agreement of clearing house members to endeavor to improve accounts which did not show this rate of return on net balances, less 12% allowance for reserves. For methods of account analysis, see case of Warren National Bank (A), *infra*.

that recent ledger balances had not been in satisfactory proportion to borrowings. After reaching this conclusion, Mr. Cartwright spoke to the treasurer of McMorrow & Company, remarking that the bank's books showed a relative falling off in balances. He added that, since the company habitually had put a good many items through the bank, and, he believed, always had received good service and courteous treatment, a moderate addition to balances would be appreciated. A week later the treasurer of McMorrow & Company reported that he had increased the balance by $1,000.

5. *City Storage Company.*—The City Storage Company had borrowed, since the time it was established in 1923, from a competitor of the Manville National Bank. The question of soliciting this company's account had been brought up by Mr. Spencer, who secured the name from Dun's *Reference Book.* An investigation, conducted by the credit department during the year 1924, resulted in sanctioning solicitation on an "approved basis."[1]

[1] All potential borrowing accounts which the Manville National Bank intended to solicit were first checked by the credit department. If this analysis showed that

When the matter of soliciting the City Storage Company's account was brought up before the bank's credit committee for final review in May, 1924, it developed that Mr. Cartwright, one of the members of the committee, was a personal friend of one of the officers of the company. Mr. Cartwright requested that negotiations be left entirely in his hands and that he be authorized to offer credit in whatever amount he saw fit.

Mr. Cartwright filed a prospect card for the City Storage Company, which merely stated that he was handling the solicitation. No further record on this prospect was made until June 19, 1929, when Mr. Cartwright advised Mr. Boyd that he had secured the account for the Manville National Bank and had promised a line of $50,000 secured by warehouse receipts covering commodities stored with the company.

6. *Carr Chemical Company.*—On December 5, 1928, Mr. Gainor, a successful paint manufacturer and a stockholder in the Manville National Bank, came into the bank to see Mr. Boyd. Mr. Gainor stated that he had been informed, on good authority, that the Carr Chemical Company, located in a neighboring city, was considering rearranging and expanding its bank lines and that he would like to see the Manville National Bank obtain some of this company's business.

Mr. Boyd knew the favorable reputation of the Carr Chemical Company and was anxious to do everything he could to bring in the account. Consequently, he asked Mr. Gainor to use his influence in the bank's favor and directed Mr. Hedges to go through the credit folders of customers who might have some connection with the company, to see whether any promising leads could be developed in that way. Mr. Boyd himself undertook to find out whether any officers or directors or other stockholders of the bank could be of help in securing an account from the Carr Chemical Company.

The only direct connection which could be discovered between the bank and the company was through Damon Brothers, Incorporated, a southern fertilizer manufacturing company, which kept

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the account would be acceptable to the bank, authority was given to solicit it on one of two bases. In cases where the credit department had been able to secure adequate information, a definite amount of credit which the bank was willing to extend was set, and the new business solicitor was authorized to offer this credit in getting the account. In contrast with this so-called "borrowing basis" was the "approved basis," which was used when the account appeared desirable on its face, although more information was necessary before a definite line could be offered.

EXHIBIT 8

Manville National Bank, Prospect Card

Name Carr Chemical Company. Address Middletown.

Industrial and agricultural chemicals.

12/5/28. Mr. Gainor gave me a lead on this concern and will work on it himself. The company is rearranging its bank lines.

—T. S. Boyd.

12/8/28. None of our officers or directors know this concern except by name. However, it sells to Damon Brothers, Incorporated, and Mr. Boyd has written the latter for a letter of introduction.

—R. Hedges.

12/10/28. Mr. Gainor telephoned to say that his friend, who tipped him off on Carr's rearrangement of lines in the first place, introduced him to several of the officers of the company yesterday.

—T. S. Boyd.

12/18/28. Went up to Middletown last Wednesday, and my letter of introduction from Damon Brothers, Incorporated, got me an interview not only with Edwin Carr, Treasurer, but with his brother John J. Carr, President.

Mr. Edwin Carr came right to the point, saying that he had met Mr. Gainor a week ago through a mutual friend and understood that we were after an account from his company. The first thing he wanted to know was how much we would be willing to lend the company, and what interest arrangements we had in mind. I mentioned a loan of $250,000, interest at 6%, and 2% on balances. He seemed satisfied but was noncommittal, saying that he would keep in touch with me by mail.

It may be that this concern is shopping around for rates, but I was favorably impressed by the Carr brothers and think that they have a business-like organization which would make a desirable customer.

—T. S. Boyd.

12/27/28. Heard from Mr. Edwin Carr to the effect that he had received a letter from Damon Brothers, Incorporated, which was decidedly complimentary to us. He added that no definite action would be taken on new lines until after the company's statement comes out next month, but that we should certainly receive consideration.

—T. S. Boyd.

1/8/29. Gainor's friend tells him that we seem to have made a good impression on the Carrs, but that he doesn't think it would do much good to press our solicitation now that we are being considered.

—T. S. Boyd.

1/23/29. Stopped in to see Mr. Edwin Carr when I was in Middletown last week, just to let him know that our interest isn't decreasing.

—T. S. Boyd.

2/11/29. Received the Carr Chemical Company's statement today, and it makes a very nice showing (see credit folder).

—R. Hedges.

2/18/29. Mr. Edwin Carr wrote, asking me to come up and see him and his brother very soon.

—T. S. Boyd.

2/26/29. I talked with the Carrs at some length about borrowing arrangements. They held out for a 5½% rate, which seems low to me. However, I accepted it and in return got them to agree to let us have a free balance of $15,000, with interest at 2% above that amount. They will be satisfied with a $250,000 line and tell me that they probably will not be extremely active borrowers until next fall.

All of the above was tentative, and Edwin Carr will let me know their final decision, based on these terms, in a few weeks.

—T. S. Boyd.

3/14/29. Mr. Edwin Carr wrote, telling me not to get impatient about their account. From this, it looks to me as though we will get it.

—T. S. Boyd.

4/2/29. Received a deposit of $20,000 today, opening the Carr Chemical Company account on the terms outlined 2/26/29.

—T. S. Boyd.

a small borrowing account at the Manville National Bank, and which bought most of its chemicals from the Carr Chemical Company. Mr. Boyd was successful in securing a letter of introduction to one of the vice presidents of the Carr Chemical Company from the treasurer of Damon Brothers, Incorporated.

The prospect card, shown in Exhibit 8, traces the bank's dealings with the Carr Chemical Company.

7. *Amos Miles.*—On May 17, 1929, the Manville National Bank received an inquiry from Amos Miles in answer to a newspaper advertisment offering to send on request a booklet entitled, "How Our Trust Department Can Help You." A few days after the pamphlet was sent, the following circular letter was mailed to Mr. Miles:

May 23, 1929

DEAR MR. MILES:

A short time ago you received the Manville National Bank's booklet, "How Our Trust Department Can Help You." We hope that by this time you have had an opportunity to read it carefully, and that it may have suggested a solution to the problems which prompted you to write for it.

Few people realize how effectively and at what reasonable cost the modern trust department can handle affairs which, to the individual, are as perplexing as they are important. We hope you have learned something of this from our booklet, but even so you do not know the whole story. We are proud of our trust service, and we want you to take advantage of it, so won't you allow us to send our trust officer, Mr. G. O. Carver, or one of his assistants, to talk it over with you?

Yours very truly,

THE MANVILLE NATIONAL BANK

On May 26 Mr. Miles came to the bank and spoke with Mr. Carver, and several days later named the Manville National Bank trustee of a fund for his young son.

8. *Antonio De Lucia.*—On May 30, 1929, Antonio De Lucia, laborer, came to the savings department of the Manville National Bank and stated that he wished to open an account in the bank's Christmas Club, making weekly deposits of $2 from that time until these accounts were closed out on December 1. Mr. De Lucia said that he had seen advertisements of the Christmas Club and that several of his friends, who had been members of this Club in previous years, had urged him to take advantage of it.

9. *Carter Stores.*—Early in June, 1929, a real estate broker who was a depositor in the Manville National Bank told Mr.

Boyd that representatives of the Carter Stores, a rapidly expanding grocery chain with headquarters in Chicago, had come to the city seeking locations.

Mr. Boyd immediately referred the matter to one of the vice presidents of the bank's Chicago correspondent, and the letters which passed between them are reproduced below.

June 3, 1929

DEAR MR. GRAYSON:

I have heard recently that the Carter Stores, the head office of which, as you know, is in Chicago, is about to enter this part of the country. Naturally, we want this account, and I am wondering if you would be able to do anything for us along this line. I don't know whether you have any connections with the concern, but any help or suggestions which you may be able to give me would be greatly appreciated.

Are you planning to attend the A. B. A. Convention this coming fall? I am looking forward to it and hope that I shall see you there.

With kind personal regards, I am

Very truly yours,
T. S. BOYD

June 10, 1929

MY DEAR MR. BOYD:

I have your letter of the 3rd with reference to the Carter Stores. Let me compliment you on your promptness in acting on this matter, for the news of Carter's entrance into the eastern territory has not broken officially even in Chicago.

It so happens that Mr. Carl Carter, President of the Carter Stores, became a director of our bank a few weeks ago. I wrote to him immediately on receipt of your letter, recommending the Manville National Bank as depositary in your city. His reply, which has just come to my desk, says that he has spoken about it to William A. Hurley, treasurer of his company, and I recommend that you get in touch with Hurley.

I too am hoping to get to the Association convention again this year, and shall be looking forward to seeing you there.

Yours very truly,
PETER GRAYSON

June 13, 1929

DEAR MR. GRAYSON:

Thank you for your favor of the 10th. I certainly appreciate what you have done for us in the matter of the Carter Stores account and hope that you will call on me whenever we can do anything to reciprocate this courtesy.

I am writing Mr. Hurley today and shall let you know what success I have.

Very truly yours,
T. S. BOYD

June 22, 1929

DEAR MR. GRAYSON:

I am pleased to be able to tell you that, after exchanging letters with Mr. William A. Hurley of the Carter Stores, I have today received word from him that the company's directors have approved the opening of an account with us.

I have you to thank for this business and certainly appreciate your kind interest and cooperation.

With warm regards, I remain

Very truly yours,
T. S. BOYD

At the conclusion of the three months' period during which the Manville National Bank had made its study of methods used for securing new business, Mr. Boyd prepared two lists, one of sources from which the bank had obtained leads on new accounts, and another of the ways in which such accounts had been secured. These lists appear below.

Lead Obtained From	Account Secured Through
1. Bank's Files. 2. Officers. 3. Directors. 4. Stockholders. 5. Customers. 6. Credit Agency Ratings. 7. Advertising.	1. Unsolicited. 2. New Service Sold to Old Customer. 3. New Account Secured through Old Customer. 4. Old Account Made Profitable or Improved. 5. Solicitation of New Accounts by: Officers. Directors. Stockholders. Employees. 6. Advertising, Circulars, Correspondence, Etc. 7. Special Services (Christmas Club, Etc.). 8. Correspondent Banks.

Mr. Boyd and Mr. Tarbell concluded from the results of this survey that, aside from unsolicited accounts, the cost of securing new business per dollar of deposits received was lowest in the cases of new accounts obtained from, or through, present customers and those personally solicited by officers and directors. Although this conclusion apparently argued against the more aggressive methods of securing new business, Mr. Tarbell was of the opinion that the latter were worth while.

WAYLAND TRUST COMPANY

CAMPAIGN FOR NEW ACCOUNTS BY THE EMPLOYEES OF A BANK

The Wayland Trust Company of Cleveland, Ohio, was established in 1910 and, through aggressive management, had grown until on December 31, 1927, it had capital and surplus of $12,378,540 and total deposits of $135,330,850. Early in 1928 Mr. Steele, the vice president of the Wayland Trust Company who was in charge of new business, determined to conduct a special campaign for new accounts by using all the employees of the bank as solicitors. In order that he might have the benefit of experience and advice in regard to the planning and carrying out of such a campaign, Mr. Steele engaged the services of W. G. Myron & Company, who specialized in supervising "drives."

After consulting with representatives of W. G. Myron & Company on the various problems involved in an undertaking of this sort, Mr. Steele called a meeting of the employees of the Wayland Trust Company, 412 in all, on February 24, 1928. At this meeting the forthcoming campaign was outlined, as follows:

I. PURPOSE

The Wayland Trust Company's new business campaign begins March 3, and ends June 2, when it will be followed by permanent sales activity in a modified form.

The campaign has been organized for the following reasons:

1. To develop aggressive salesmanship throughout the organization and thus to create a source of much profitable new business.

2. To secure a larger portion of the new business available in Cleveland and to maintain a consistent competitive advantage through continuous sales effort after the campaign itself is closed.

II. ORGANIZATION

Three sales divisions will be organized, as follows:

1. The main office, which will be divided into six groups, each headed by an officer.

2. Three of the larger branches, each of which will be divided into two groups headed, respectively, by the branch manager and assistant branch manager.

3. The twelve remaining branches, each of which will constitute a group with the branch manager at its head.

Solicitation by employees is to be carried on entirely outside of banking hours, unless special permission to the contrary is secured from the group head.

III. QUOTAS

The total quota for the new business campaign is $2,000,000 credit on the method of scoring explained below. This total is assigned to the sales divisions, as follows:

Division A	$1,150,000
Division B	400,000
Division C	450,000

Each group within these divisions has a quota, ranging from $350,-000 for the main office group headed by Mr. Steele, to $20,000 for the smallest branch.

IV. CREDITS AGAINST QUOTAS

The different types of business to be sought in this campaign have been given the following dollar values, which will count as credits against quotas:

Checking Accounts.—Amount deposited when account is opened.

Checking accounts are to be solicited on the understanding that they will be opened with a deposit of $300 or over. No credit will be given for accounts opened with a smaller deposit.

Any checking account which is promised contingent upon the extension of credit to the prospective depositor must be referred to the head of the group of which the solicitor is a member. If the bank approves such extension of credit, the solicitor will be given full credit for the amount of the initial deposit to the new account.

Credit will not be allowed for new checking accounts opened by persons already having checking accounts at the Wayland Trust Company, nor for the reopening of checking accounts closed after February 18.

Savings Accounts.—Amount deposited when account is opened.

Savings accounts are to be solicited on the understanding that they will be opened with a deposit of $25 or over. No credit will be given for accounts opened with a smaller deposit.

Credit will not be allowed for new savings accounts opened by persons already having savings accounts at the Wayland Trust Company, nor for the reopening of savings accounts closed after February 18.

Safe Deposit Boxes.—One hundred dollars credit for each $1 of the first year's rental.

Wills.—Five per cent of the value (as estimated by the Trust Department) of the estate covered by a will naming the Wayland Trust Company executor, and 5% of the estimated value of any trusts created under such will in which the Wayland Trust Company is named trustee.

Insurance Trusts.—Ten per cent of the face value of the policies deposited under such trust.

Custodianships.—Twenty per cent of the amount of each custodianship.

Living Trusts.—Seventy-five per cent of the value of the property transferred to the Wayland Trust Company under each trust agreement.

Corporate Trusts.—In proportion to credit for living trusts, based on income from the particular corporate trust.

Miscellaneous.—In the discretion of the officers' campaign committee headed by Mr. Steele.

V. TROPHIES

To encourage competition among the groups, three silver cups are being offered, one in each sales division.

The new business campaign will be divided into 13 weeks, and group quotas will be similarly divided.

At the close of business on each Saturday during the campaign, the percentages of weekly quotas produced during the preceding week will be calculated for each group. Trophy points will be awarded weekly to groups within each sales division, as follows:

Greatest Percentage of Quota	**35 points**
Second Highest Percentage of Quota	**20 "**
Third Highest Percentage of Quota	**15 "**
Fourth Highest Percentage of Quota	**10 "**

At the end of the campaign, the groups in each sales division which finish first and second in total trophy points will be declared joint winners of the cups offered in their respective divisions.

VI. BONUSES

Cash bonuses will be paid to employees of the bank for all new business secured. Bonuses will not be paid to branch managers, full-time new business solicitors, officers, directors, or stockholders. Bonuses will be calculated on the following basis:

Checking Accounts.—One-half of 1% of the average daily balance of the account for the first three months following the opening of the account, provided the account is still open at the end of this time. No bonus will be paid on accounts which show an average daily balance of less than $300. The maximum bonus on any one account will be $50.

Savings Accounts.—One-half of 1% of the minimum balance of the account during the first three months following the opening of the account, plus a fixed bonus of 50 cents per account. No bonus will be paid on accounts which show a minimum balance of less than $25. The maximum bonus on any one account will be $15.

Safe Deposit Boxes.—Twenty per cent of the first year's rental charge.

Wills.—Ten cents per $1,000 of the estimated value of the estate.

Insurance Trusts.—Twenty-five cents per $1,000 of the policies deposited.

Custodianships.—Twenty-five cents per $1,000 of property covered by the agreement.

Living Trusts.—Fifty cents per $1,000 of property transferred to the Wayland Trust Company.

Corporate Trusts.—On the basis of income compared with income on living trusts.

VII. SCORE CHARTS

Score charts showing the progress of each of the three sales divisions will be prepared daily and posted in the main office for Division A, and in the appropriate branch offices for Divisions B and C.

VIII. REPORTS

Credits against quotas and individual bonuses will be allowed only on receipt of prospect report cards (see Exhibit 1), properly filled out and turned over to group heads.

EXHIBIT 1

Wayland Trust Company, Prospect Report Card

Name of Prospect		
Address of Prospect		
Type of Account Solicited:		
Checking	Will	Custodianship
Savings	Insurance Trust	Corporate Trust
Safe Deposit	Living Trust	Other
Date Solicited		Date Account to Be Opened
Remarks		
Salesman's name		Sales Division and Group

IX. INDIVIDUAL AWARDS

At the close of the new business campaign, three classes of individual awards will be made in the form of medals:

Blue Ribbon Medal	
Employees	30 accounts, or $10,000 credit
Junior Officers and Branch Managers	$30,000 credit
Senior Officers and Directors	$100,000 credit
Red Ribbon Medal	
Employees	15 accounts, or $5,000 credit
Junior Officers and Branch Managers	$15,000 credit
Senior Officers and Directors	$50,000 credit
White Ribbon Medal	
Employees	5 accounts, or $2,500 credit
Junior Officers and Branch Managers	$7,500 credit
Senior Officers and Directors	$25,000 credit

X. THE THIRTY LEADERS

To reward further the 30 best producers of new business among the employees, a weekly competition will be held. Branch managers, officers, and directors are not eligible for this competition.

Each week the employee producing the largest number of dollars of new business credit will be awarded 30 points, the next 29, and so on, down to 1. Similarly, 30 points to 1 point will be awarded weekly to the employees obtaining the largest number of new accounts.

Lists showing the points awarded each week will be posted on Wednesday of the succeeding week, and a cumulative list of the 30 leaders will be posted at the same time.

At the close of the campaign the 30 leaders will be rewarded, as follows:

1	$125.00	plus an extra week's vacation
2	100.00	plus an extra week's vacation
3	75.00	plus an extra week's vacation
4	62.50	plus an extra week's vacation
5	50.00	plus an extra week's vacation
6	50.00	
7	45.00	
8	40.00	
9	35.00	
10	30.00	
11–15	25.00	
16–20	12.50	
21–25	7.50	
26–30	5.00	

XI. BULLETINS AND MEETINGS

Bulletins giving information and news concerning the campaign will be issued twice a week, or oftener, and posted in each office.

Sales meetings will be held every other Friday evening commencing March 2. These meetings will be designed to furnish aid to contestants and to sustain enthusiasm. They will be addressed by representatives of W. G. Myron & Company and by officers, directors, and branch managers of the Wayland Trust Company.

XII. CAMPAIGN COMMITTEE

A committee composed of officers of the bank has been appointed to decide on all matters pertaining to the campaign. All questions and complaints should be addressed to Mr. Steele, chairman of this committee, or to one of its members.

The immediate results of the new business campaign, and the subsequent performance of accounts obtained thereby, were tabulated by Mr. Steele, as follows:

Total credits against quotas—$5,561,040, or 278% of the original $2,000,000 quota for the organization as a whole.

Total number of new customers secured—5,052, as a result of solicitation of 10,599 prospects. (An average of 23 solicitations and 11 new customers for each employee, officer, and director.)

During the campaign, 1,907 other new accounts, credits totaling $3,032,085, came in, but were classified as unsolicited, credit not being given in the campaign.

New Accounts Secured

Type of Account	Number of Accounts	Total Dollar Credit
Savings	3,683	$1,201,818
Checking	1,916	2,979,240
Safe Deposit Boxes	1,620	412,470
Wills	188	928,637*
Life Insurance Trusts	15	38,875†
Total	7,422	$5,561,040

* Value of estates, $18,572,750.
† Value of policies, $388,750.

New Business Secured

By	Number of Customers	Total Dollar Credit
Officers	208	$1,879,460
Directors	16	486,460
Stockholders	.....	....
Main Office Employees	209	741,930
Branch Employees	4,619	2,453,190
Total	5,052	$5,561,040

Performance of Accounts Brought In by the Campaign during the First Three Months after Its Close

Type of Account	Balances	% Loss of Accounts
144 Checking Accounts Closed	$166,833	5.6
520 Savings Accounts Closed	112,222	9.3

Cost of the Campaign

Printing and Supplies	$ 1,084
Charts and Posters	459
Medals and Cups	237
Meeting Rooms	760
Office Rent	150
Staff Salaries	1,087
Miscellaneous	74
Fee, W. G. Myron & Company	7,500
Cash Bonuses and Prizes	6,654
Total	$18,005

$2.43—Cost of each new account.
2.66—Cost of each new account remaining with bank three months after close of campaign.
3.56—Cost of each new customer.
.32—Cost of each $100 credit for new accounts.
.34—Cost of each $100 credit for new accounts remaining with bank three months after close of campaign.

On Monday, June 11, following the meeting at which the results of the campaign had been announced and prizes awarded, Mr. Steele called together the 205 officers, directors, and employees who had received individual medals for their ability in the solicitation of new business. This group was to continue as a permanent staff of solicitors under the following plan:

I. ORGANIZATION

The monthly quota of the new business solicitors will be $375,000 credit. The types of business to be sought will continue the same as during the campaign, and credits against quotas will be awarded on the same basis.

The total monthly quota is to be divided among the following 19 groups:

Officers and Directors	1 group
Main Office Employees	3 groups
Fifteen Branch Offices	15 groups

II. REWARDS

No monetary rewards, trophies, or medals will be offered, but the individual performance of every solicitor will be closely watched, and consistent producers of new business will be rewarded by salary increases and promotions.

III. REPORTS

Solicitors will continue to use the prospect report cards employed during the campaign, and no credit will be given for new accounts except against these cards properly filled out and submitted to group heads.

IV. MEETINGS AND BULLETINS

Meetings of solicitors will be held monthly. A bulletin, showing the progress made against quotas and containing information of interest, will be issued twice a month to all solicitors.

V. NEW BUSINESS COMMITTEE

The activities of the solicitors will be under the general supervision of the same committee which functioned during the campaign. Among the duties of this committee will be the adding to or dropping from the list of solicitors the name of any employee whose record justifies such action.

After the permanent staff of new business solicitors had been functioning for four months, Mr. Steele prepared the following record of its productivity:

New Accounts Secured

Type of Account	Number of Customers	Total Dollar Credit
Savings } Time Deposit }	846	{ 523,722 500,000
Checking	502	1,148,001
Safe Deposit Boxes	144	74,850
Wills	28	121,188
Life Insurance Trusts	3	21,940
Total	1,523	2,389,701
Prospects Solicited	3,558	

New Business Secured

By	4 Months' Quota	4 Months' Credit
Officers and Directors	$ 200,000	$ 134,575
Main Office Employees	450,000	1,161,108
Branches	1,150,000	1,094,018
	$1,800,000	$2,389,701

What was the ratio of "sales" to "prospects"? What was the percentage of failures in "sales" subsequent to the campaign?

What was the cost per dollar of new deposits obtained by this plan? What percentage of these deposits could prove temporary and yet leave the cost per dollar reasonable, as compared with the purchase of deposits from an established bank?

Was the business secured during the Wayland Trust Company's campaign appreciably cheaper, per dollar of deposits, than that ordinarily brought in by full-time new business solicitors and by officers and directors? Should one expect that the accounts brought in during the campaign would prove to be as profitable to the Wayland Trust Company as those secured through the usual methods of solicitation?

Were sufficient precautions taken against the bringing in of undesirable new business and the possible creation of ill will, in the event that the bank should be forced later to seek improvement or elimination of accounts which had been solicited by its representatives?

18. SEEKING NEW LOAN OUTLETS

CHARLES FAIRBANKS COMPANY

INTEREST RATE COMPETITION FOR BORROWING CUSTOMERS

During May, 1930, Mr. McGrath, a vice president of the Garfield National Bank of Providence, Rhode Island, learned that the president of the Charles Fairbanks Company was desirous of forming a banking connection in that city. The Charles Fairbanks Company was a small but long-established manufacturer of high-grade worsted suitings. The company, which was located in a near-by Rhode Island town, had borrowed for some years at a local bank which always had charged 6% for its money. Mr. Fairbanks had not been satisfied with this uniform rate, and, when the bank refused to make any reduction in spite of the easy money conditions prevailing in the New York money market[1] in the spring of 1930, he decided to seek a bank credit line in Providence.

The possibility of securing the account of the Charles Fairbanks Company had been brought to the attention of the Garfield National Bank during the spring of 1928, but no action was taken at the time because of the attitude of the company's local bank. This local bank maintained a substantial account at the Garfield National Bank and had requested that the latter refrain from soliciting the account of the Charles Fairbanks Company. It felt competent to handle the company's business and did not wish to lose a valuable customer.

In 1930, however, Mr. McGrath determined to solicit the account, since it appeared certain that the company would cease borrowing locally and it was known that another Providence bank, where Mr. Fairbanks kept a personal account, was anxious to obtain the company as a customer. Another factor which Mr. McGrath took into consideration was that Mr. Fairbanks, a man 70 years of age with considerable personal means, appeared to be an excellent prospect for the trust department of the Garfield National Bank.

[1] For data on open-market rates and prevailing rates charged customers by banks in principal cities, see *Federal Reserve Bulletin*, June, 1930, pp. 347–348. For open-market rates, consult Appendix III. Consult: Riefler, W. W., *Money Rates and Money Markets in the United States*, especially Chs. IV–V.

Mr. McGrath obtained the Charles Fairbanks Company balance sheets for the five latest years, as shown in Exhibit 1, and also secured a considerable amount of general information concerning the company. He found that the operating loss shown in 1929 was ascribed to the depressed condition of the woolen industry rather than to conditions within this particular concern, and that the company ordinarily borrowed at the bank only from about February 1 to June 1, being out of debt for the remainder of the year. Peak requirements were between $75,000 and $100,000, and the average monthly balance at the local bank had been $35,000 during 1929. In an interview Mr. Fairbanks stated that he believed 5% to be a fair rate of interest to pay on loans in the spring of 1930, and that he was willing to receive no interest on balances while the company was in the bank's debt, if 2% were paid at other times.

EXHIBIT 1

Financial Statements of the Charles Fairbanks Company, as of December 31, 1925 to 1929*

	1925	1926	1927	1928	1929
Assets					
Cash	$ 17,700	$ 37,631	$ 75,756	$ 47,561	$ 6,972
Accounts Receivable	147,213	60,795	56,542	143,877	166,638
Merchandise	306,131	249,616	229,299	269,084	177,616
Cash Value Life Insurance	3,830	5,402	6,019	6,621	7,201
Current Assets	$474,874	$353,444	$367,616	$467,143	$358,427
Land, Buildings, and Equipment	250,172	250,353	287,646	290,199	303,860
Investments	146,137	133,110	125,649	110,544	130,424 †
Deferred Charges and Prepaid Items	1,258	3,455	610	863	2,175
Tenements	13,050	12,976	12,979	12,979	12,979
Total Assets	$885,491	$753,338	$794,500	$881,728	$807,865
Liabilities					
Notes Payable—Borrowed Money	$ 2,277	$ 2,277	$ 2,277	$ 2,277	$ 27,277
Accounts Payable	206,413	99,263	120,288	194,000	105,824
Accruals	41,400	....	....	....	....
Reserve for Taxes	11,084	4,701	5,556	5,713	3,198
Current Liabilities	$261,174	$106,241	$128,121	$201,990	$136,299
Reserve for Depreciation	130,844	141,352	147,801	150,367	156,912
Reserve for Contingencies	5,000	....	1,994	....	....
Common Stock	300,000	300,000	300,000	300,000	300,000
Surplus	188,473	205,745	216,584	229,371	214,654
Total Liabilities	$885,491	$753,338	$794,500	$881,728	$807,865
Net Profits	$ 13,129	$ 19,399	$ 37,674	$ 40,563	$ 10,797 (d)
Dividends Paid	35,161	2,128	26,834	33,627	4,500
Current Ratio	1.81–1	3.32–1	2.86–1	2.31–1	2.62–1
Net Worth—Debt	1.87–1	4.76–1	4.03–1	2.62–1	3.77–1
Net Worth—Fixed Assets	3.68–1	4.14–1	3.38–1	3.46–1	3.21–1
Merchandise—Receivables	2.07–1	4.10–1	4.05–1	1.87–1	1.06–1
Acid Test	.63–1	.92–1	1.03–1	.94–1	1.27–1
Profit on Net Worth	2.68 %	3.83 %	7.29 %	7.66 %	....

* Statements are not audited but are signed by the president of the company.
† Checked by bank and valued at approximately $100,000 as of 5/23/30.
(d) Deficit.

WEET'S DEPARTMENT STORE

EXTENSION OF CREDIT BY MEANS OF A TERM LOAN

At the daily meeting of the loan committee of the Spencer National Bank of Chicago on November 10, 1938, a proposal for a five-year unsecured loan of $250,000 to Weet's Department Store was being considered. The suggested arrangement called for repayment of at least $50,000 a year, prepayments at any time being permitted. For some time the management of the store had had under consideration the expansion of its real estate holdings through certain improvements to cost not more than $325,000; the proceeds of the loan would be used for this purpose. The company was willing to sign a contract agreeing not only to maintain a minimum working capital position but also to refrain from selling, pledging, or allowing to become encumbered any of its real estate during the life of the loan. Changes in the company's plant investment during the preceding 10 years may be found in the comparative balance sheets presented in Exhibit 1; the company's earning record for the same period is shown in the operating statements given in Exhibit 2.

Established in Des Moines, Iowa, in 1891, Weet's Department Store had a record of steady progress with neither serious setbacks nor spectacular growth. Most of the company's capital stock remained in the family of the founder of the business. The president, a son-in-law, and the vice president, a son, actively directed the organization. Each department manager was given a maximum of independence and was encouraged to assume as full responsibility as was compatible with control and coordination. To maintain its reputation for quality merchandise, Weet's Department Store carried medium-price to high-price lines in all departments. About 40% of the sales was for cash and the balance was on regular charge account terms. There were two other large department stores in the city, one of which approached but did not equal Weet's store in quality, while the other was distinctly cheaper.

Weet's Department Store had been a customer of the bank since 1928. About 1925, when the store's peak short-term credit

EXHIBIT 1

Balance Sheets of Weet's Department Store, as of December 31, 1929 to 1937
(000 omitted)

	1929	1930	1931	1932	1933	1934	1935	1936	1937
Assets									
Cash	$ 32	$ 17	$ 91	$ 120	$ 31	$ 125	$ 115	$ 107	$ 100
Customers' Accounts and Notes Receivable (Net)	483	493	403	318	293	301	327	370	375
Inventory	667	615	472	325	365	363	378	396	422
Readily Marketable Securities						2	2	4	1
Total Current Assets	$1,182	$1,125	$ 966	$ 763	$ 689	$ 791	$ 822	$ 877	$ 898
Land and Buildings (Net)	408	392	376	360	344	328	312	296	405
Equipment and Fixtures (Net)	103	96	74	58	49	44	146	133	119
Customers' Accounts Receivable over 6 Months	50	28	54	48	112	66	58	41	46
Receivables from Officers, Partners, and Directors	....	12	13	15	33	25	42	17	19
Securities of Subsidiaries and Affiliations*	138	137	137	127	122	7	7	9	9
Real Estate Not Used in Business	288	287	282	277	272	273	268	263	259
Other Assets	31	22	24	114	165	81	32	27	31
Total Assets	$2,200	$2,099	$1,926	$1,762	$1,786	$1,615	$1,687	$1,663	$1,786
Liabilities									
Accounts Payable	$ 90	$ 71	$ 30	$ 22	$ 87	$ 44	$ 76	$ 39	$ 88
Personal Account and Unpaid Dividends	120	131	12	37	13	38	57	38	58
Notes to Banks and Brokers	30	.....	.....	.....	25	.....	.....	.....	31
Provision for Accruals, Taxes, and Self-Insurance	142	138	123	114	119	127	139	146	161
Total Current Liabilities	$ 382	$ 340	$ 165	$ 173	$ 244	$ 209	$ 272	$ 223	$ 338
Funded Debt	71								
Common Stock	1,250	1,250	1,250	1,248	1,236	1,237	1,224	1,250	1,250
Earned Surplus	497	509	511	341	306	169	191	190	198
Total Liabilities and Net Worth	$2,200	$2,099	$1,926	$1,762	$1,786	$1,615	$1,687	$1,663	$1,786
Reserve for Doubtful Receivables	$ 12	$ 12	$ 12	$ 16	$ 22	$ 22	$ 22	$ 22	$ 22
Working Capital	$ 800	$ 785	$ 801	$ 590	$ 455	$ 582	$ 550	$ 654	$ 560
Cash and Receivables to Current Liabilities	1.35	1.50	2.99	2.53	1.33	2.04	1.63	2.14	1.41
Current Assets to Current Liabilities	3.09	3.31	5.85	4.41	2.82	3.78	3.02	3.93	2.66
Net Worth to Total Liabilities	3.86	5.17	10.67	9.18	6.32	6.73	5.20	6.46	4.28
Average Number of Days Receivables Outstanding	55	58	54	56	56	50	50	52	50
Turnover of Inventory Based on Cost of Sales (in Days)	.....	117	109	102	102	95	89	86	88

* Buying organization no longer active.

EXHIBIT 2

Operating Statements of Weet's Department Store for the Years Ending December 31, 1928 to 1937
(000 omitted)

	1928	1929	1930	1931	1932	1933	1934	1935	1936	1937
Net Sales	$3,212	$3,200	$3,099	$2,717	$2,084	$1,908	$2,216	$2,402	$2,597	$2,713
Cost of Goods Sold	1,974	2,015	2,000	1,824	1,427	1,235	1,396	1,531	1,646	1,704
Gross Profit	$1,238	$1,185	$1,099	$ 893	$ 657	$ 673	$ 820	$ 871	$ 951	$1,009
Selling, Administrative, and General Expense	1,018	996	978	923	765	702	769	807	889	933
Operating Profit	$ 220	$ 189	$ 121	$ 30(d)	$ 108(d)	$ 29(d)	$ 51	$ 64	$ 62	$ 76
Other Expense										
Notes and Accounts Written Off	......	......	......	$ 17	$ 32	$ 20	$ 28	$ 16	$ 14	$ 12
Interest Paid	......	......	......	2	......	1	2	......	......	1
Miscellaneous	$ 27	$ 45	$ 21	2	13	16	5	2	2	3
Federal Tax	32	25	17	1	......	......	6	8	11	15
Total Other Expense	$ 59	$ 69	$ 38	$ 22	$ 45	$ 37	$ 41	$ 26	$ 27	$ 31
Other Income										
Interest Earned	......	......	......	$ 4	......	$ 10	$ 8	$ 11	$ 10	$ 10
Bad Debts Recovered	......	......	......	5	$ 5	4	7	7	6	5
Miscellaneous	$ 20	$ 19	$ 6	1	8	1	4	7	5	1
Leased Property (Net)	48	49	48	50	47	28	28	28	27	28
Total Other Income	$ 68	$ 68	$ 54	$ 60	$ 60	$ 43	$ 47	$ 53	$ 48	$ 44
Net Profit or Loss	$ 299	$ 188	$ 137	$ 8	$ 93(d)	$ 23(d)	$ 57	$ 91	$ 83	$ 89
Dividends	*	$ 125	$ 125	$ 0	$ 76	$ 8	$ 45	$ 67	$ 88	$ 81

* Not available.
(d) Deficit.

requirements began to exceed the legal limit of the local bank, notes were sold in the open market for periods of about four months each year. Although in 1931 the Spencer National Bank had voluntarily set up a line of credit of $300,000, later reduced at the company's suggestion to $200,000, the store did not borrow from it until 1935. Up to that time Weet's store had continued the sale of commercial paper in the open market because of the lower rate available. In the fall of 1935, the company borrowed $62,500 for 60 days; from October 14 to December 22, 1936, it used $100,000; on October 28, 1937, it borrowed $125,000, which was reduced to $31,000 by the end of the year and was repaid in full in June, 1938. In the following September, the company had borrowed $62,500, which was outstanding on November 10, 1938.

EXHIBIT 3
Description of Real Estate of Weet's Department Store
(Excerpt from a credit report)

Weet's Department Store is located in Des Moines, Iowa, at the intersection of Main Street, the most important thoroughfare in the downtown shopping district, and 8th Avenue, an important cross street. The property occupied consists of the following: a 2-story building on the corner, which is on land leased until 1990, measuring 50 feet on Main Street by 150 feet on 8th Avenue; a 5-story building immediately adjoining on 8th Avenue, owned in fee simple, measuring 70 feet by 100 feet; an 8-story building adjoining the corner property on Main Street located on a lot having a frontage of 75 feet and a depth of 150 feet. The last-mentioned lot is one-third leasehold—expiring in 1989—and two-thirds owned in fee. One-third of the fee was purchased for $125,000 in 1937. All the buildings were built during the period from 1910 to 1922. In 1935 complete air-conditioning of the first floor and basement was installed at a cost of about $100,000. The fixed assets are carried on the books at depreciated cost, although property values in the districts have appreciated considerably during the past 20 years. In addition to the store property occupied, the company has owned for many years two stores adjoining the Main Street section. These were acquired to protect the neighborhood with a view to possible future expansion and as an investment. Each of the two stores is on a lot fronting 50 feet on Main Street with a depth of 150 feet.

The proposed building program included the erection of an eight-story building on the lot adjacent to Weet's Department Store at a cost of $225,000 and the rebuilding of the existing five-story building next adjacent at a cost of $100,000. The former was to be occupied eventually by Weet's store, except for the first floor and half of the basement. The rented space was to be leased to a responsible tenant, then occupying the existing building, for a minimum rental of $12,500 per annum. The second building would be occupied exclusively by a men's clothier, whose sales volume was then about $800,000. The building was to be let under a 35-year lease calling for a minimum guaranteed rental

of $18,750 per annum, or 3½% of sales up to $800,000 and 3% of sales over $800,000, in addition to payment of all taxes, insurance, and maintenance.

The proposed loan of $250,000 for 5 years would be in addition to the $200,000 line of credit which the committee believed should amply cover the usual seasonal requirements during two or three months preceding Christmas. As the firm's real estate was all clear, mortgage security could be taken, but the committee thought greater flexibility and less expense would result if the advance could be made on an unsecured basis, provided the credit of the company justified such treatment. A description of the property, taken from a credit report on the store, is given in Exhibit 3.

In 1922, purchase of a portion of the property occupied was financed by a mortgage bond issue of $250,000 to mature in 1937, underwritten by a local trust company. After 5 years the bonds became callable at a premium, and from 1927 to 1929 substantial reductions were made annually. The remaining bonds were called in 1930.

When granting a term loan, a bank might require a company to accept some of the following conditions:

1. To keep a minimum amount of working capital, or a minimum current ratio;
2. To keep within a maximum debt limit;
3. To agree that the compensation of officers and directors would not exceed that for the calendar year preceding the date of the loan request;
4. To give no pledge of or mortgage on fixed or current assets;
5. To purchase no fixed assets;
6. To sell receivables only without recourse;
7. To make no merger or consolidation or purchase of subsidiaries;
8. To guarantee no obligations of others;
9. To pay no dividends until all payments of principal due and interest accrued at that time on the loan have been met;
10. To offer all other short-term borrowing, including sale of commercial paper, to the lending bank first;
11. To increase the interest rate an amount equal to any rise which might occur in the Federal reserve discount rate on 90-day commercial paper;

12. To make all payments of principal, interest, taxes, and insurance when due.

Failure to observe any one of the conditions agreed upon would accelerate the maturity of the loan to that of a demand note. Appraise each as to the protection it affords the bank. Appraise each as to the reasonableness of the limitation imposed on the freedom of action of the management.

Is it necessary to amortize a loan fully during its term? Under what circumstances would it be sound policy to arrange for a large payment at the longest maturity far in excess of any one of the intervening serial amortization payments?

How should the credit analysis for a term loan differ from that for a commercial loan?

BERRY PRESERVE COMPANY

LARGER LOANS BY THE USE OF FIELD WAREHOUSING[1]

At the beginning of 1931 the Berry Preserve Company needed about $2,000,000 to finance the canning and selling of its 1931 pack. The company was engaged in the business of canning and selling fruits and vegetables of all kinds, which were sold throughout the United States under the nationally advertised "Berry" label and long-established brand names. The management was highly regarded by the banks in the city in which the company was located, and for many years the company had been granted open credit lines adequate to care for its seasonal needs. In November, 1930, the company had been forced to borrow heavily from the banks, and because of reduced sales volume, low prices, and slow collections, it had been unable to liquidate these obligations as rapidly as in previous years. The bank debt carry-over from the 1930 pack amounted to $2,500,000. In 1931, therefore, the local banks would not give the usual assurance of financing for the year.

Mr. Berry, president of the company, faced with the necessity of raising $2,000,000 from new sources, approached a large New York bank with a request for the necessary funds. The New York bank disapproved an unsecured line on the basis of the financial statements submitted by the company, shown in Exhibits 1 and 2, but stated that it would be glad to grant an acceptance line upon the basis of pledged security and to market such drafts drawn on the company. The most desirable security available for the acceptance line was about $5,000,000 of inventory carried over from the 1930 pack, but this merchandise was not satisfactory to the bank. After further negotiation, an agreement was reached that the bank would take as security warehouse receipts on the new pack, if issued by a bona fide warehouseman.

The channels of distribution customarily utilized by the Berry Preserve Company did not include regular storage warehouses, and the management was convinced that the temporary use of such warehouses would not be feasible because of the excessive costs of

[1] See United States Bureau of Agricultural Economics, *Field Warehouse Receipts*, Yohe, H. S.; reprinted in *Federal Reserve Bulletin*, June, 1937, pp. 513–521.

EXHIBIT 1

Balance Sheets of the Berry Preserve Company, as of January 31, 1930, and 1931

	1930	1931
Assets		
Cash in Banks and on Hand	$ 546,679	$ 462,973
Accounts and Trade Acceptances Receivable, Net*	1,156,887	1,111,233
Inventories†	3,224,420	5,317,200
Current Assets	$4,927,986	$ 6,891,406
Investments in Affiliated Companies	163,125	157,581
Real Estate, Plants, and Equipment	7,855,523	8,115,949
Less Reserve for Depreciation	4,160,547	4,436,745
Net Fixed Assets	$3,694,976	$ 3,679,204
Prepayments and Deferred Charges	40,806	33,798
Total Assets	$8,826,893	$10,761,989
Liabilities		
Accounts Payable and Accruals	$ 434,637	$ 374,483
Bank Loans	400,000	2,500,000
Current Liabilities	$ 834,637	$ 2,874,483
6% Convertible Gold Notes—Held by Public, Due May 1, 1932	2,625,000	2,598,000
Reserve for Contingencies	172,925	187,403
Cumulative Convertible Preferred Stock (No Par Value) 60,000 Shares	5,100,000	5,100,000
Common Stock (No Par)	656,141	672,806
Deficit	561,810	670,703
Total Liabilities	$8,826,893	$10,761,989

* Reserves were $145,397 on January 31, 1931, and $149,781 on January 31, 1930.
† Valued at the cost level of the lowest cost year subsequent to production.

transportation. Accordingly, the company engaged the services of the Lawrence Warehouse Company for the purpose of installing a field warehouse at each of the packing company's 19 plants.[1]

As the first step in establishing these field warehouses under the Lawrence System, the Lawrence Warehouse Company leased from the Berry Preserve Company certain easily segregated sections of the latter's premises. These leases were recorded in the county in which the properties were located. Next, the Lawrence

[1] The Lawrence Warehouse Company conducts a nation-wide specialized service consisting of the establishment and operation of numerous field warehouses. The warehousing company frequently takes the initiative in seeking situations wherein it believes a borrower would find it advantageous to convert his borrowing operations to the form of a pledge of specific commodities.

Other large field warehousing companies are the Haslett Warehouse Co., the St. Paul Terminal Warehouse Co., the Douglas-Guardian Warehouse Corp., and the Terminal Warehouse Co. of New York.

EXHIBIT 2

Income Statements of the Berry Preserve Company, as of January 31, 1930, and 1931

	1930	1931
Net sales	$11,050,405	$8,838,377
Less Cost of Sales (before Depreciation)	8,219,772	6,338,954
Gross Profit	$ 2,830,633	$2,499,423
Expenses—Selling, Advertising, Shipping, Administrative, and General	2,133,737	2,064,783
Operating Income	$ 696,896	$ 434,640
Other Income (Net)	8,031	29,594
Net Profit before Interest and Depreciation	$ 704,927	$ 464,234
Interest	228,062	246,945
Net Profit before Depreciation	$ 476,865	$ 217,289
Depreciation	406,784	337,035
Net Profit for the Year	$ 70,081	$ 119,746(d)

(d) Deficit.

Warehouse Company entered into a warehousing agreement with the Berry Preserve Company concerning the period of storage, the rules of operation, and other details.

Having concluded the foregoing agreements, the Lawrence Warehouse Company placed signs on the property which had been leased to it. The signs were so posted that any prudent person approaching the leased property would be notified that a warehouse had been established, and that the commodities contained therein were in its custody. All entrances to the leased property were securely locked with Lawrence Warehouse Company locks, and the keys to such locks were placed in the custody of bonded warehouse managers employed under written contract by the warehousing company. The leased property then was put under the supervision of the warehouse managers and bonded watchmen. The warehousing company issued specific written instructions to its warehouse managers and watchmen directing them to observe rigidly its regulations covering such matters as exclusive possession of the keys, requisites for admission or release of warehouse commodities, and prohibition of the substitution of commodities.

The employees at the warehouses were on the payroll of the Lawrence Warehouse Company, and written employment agreements were made with all employees except common labor. The warehousing company also maintained a staff of examiners who

checked the records and inventory in these as well as in many other field warehouses 12 times a year at irregular intervals. The warehousing company, in the regular course of its business, maintained an "All Risk Liability Insurance Policy" secured from Lloyd's, underwriters of London, which covered, in addition to acts subject to warehousemen's legal liability, the fidelity of all employees of the company.

The direct costs involved in the establishment and operation of the warehouses were to be charged to the Berry Preserve Company in a warehousing fee payable monthly in advance. In addition, the Berry Preserve Company was to pay a field warehouse fee of one cent per case of commodities warehoused by the depositor per season; provided, however, that the aggregate of such field warehouse payments should not exceed ½ of 1% per annum of the aggregate principal amount of drafts discounted and other borrowings by the Berry Preserve Company which were at any time secured by warehouse receipts issued by the Lawrence Warehouse Company; provided further, however, that the annual minimum field warehouse fee should not be less than $5,000. This amount was not uniform for all customers of the Lawrence Warehouse Company but was set in advance after due consideration of the probable supervision costs incurred by the warehousing company, including preliminary fieldwork, general legal expense, and examinations.

As the Berry Preserve Company proceeded with the canning of the 1931 pack, the canned goods were received by the bonded warehouse managers, placed in the field warehouses, and conspicuously identified by stack cards. Each warehouse manager sent reports covering each installment of goods received into the warehouse to the Lawrence Warehouse Company's regional office, which thereupon issued warehouse receipts to the packing company. The latter forwarded the receipts to a local bank, which, as custodian for the New York bank, held them for the equal and ratable security of all drafts drawn. The local bank also received all the drafts drawn upon the Berry Preserve Company, authenticated them, and forwarded them to the New York bank. The latter accepted the drafts and sold them in the money market at the best obtainable bid rate. The New York bank received an acceptance commission of 2% per annum on the face amount of the drafts, with an agreement that the aggregate of such accept-

ance commissions and the discount upon drafts sold should not be less than 5½% per annum on the face amount of such drafts.

When sales were made, canned goods were released only on order of the New York bank, although, as a practical matter, the latter delegated most of this authority to its custodian, which in turn worked out an arrangement with the packing company, so as not to interfere with operations. Each release order was accompanied by a warehouse receipt upon which a notation was made by the warehousing company of the amount of merchandise released. Merchandise was released to the Berry Preserve Company only after payment of the amount borrowed thereon. The New York bank had in its control at all times either warehouse receipts for the goods pledged on outstanding drafts or an equivalent amount of cash.

The company's borrowings secured by warehouse receipts reached a peak of $2,000,000 during the 1931 season.

Appraise the decision of the New York bank not to loan upon an unsecured basis.

Why did the New York bank accept the 1931 pack as security and refuse to take the inventory on hand?

Why would not the local banks extend the necessary credit on a secured basis?

In what situations is field warehousing more advantageous than regular storage warehousing?

What, if any, are the disadvantages of field warehousing?

How would the accepting bank determine the limit of the amount to be loaned upon the pledged commodity in this case?

AURORA BANK

INSURANCE PREMIUM FINANCING

Early in 1939 the Aurora Bank of Ithaca, New York, was considering the adoption of the "Stevens Plan"[1] for developing a profitable loan volume in connection with the financing of insurance premiums. The adoption of the plan would involve a small outlay by the bank for supplies, a part of the cost of one clerk who would be assigned on a part-time basis to handle the details of loans made under the plan, and a part of the cost of one of the bank's executives who would be designated to devote a part of his time to promotional work among local insurance agents. If the bank had had an installment loan department, no additional personnel would have been required.

If the bank decided to adopt the Stevens Plan, it would be the first bank in Ithaca or thereabouts to do so. Elsewhere 151 banks in 30 states were using it. Competition could be expected from certain finance companies which were offering similar plans of premium financing. Some of these companies, notably the First Bancredit Corporation, were well entrenched with the larger insurance companies.

In broad outline, the Stevens Plan provided that banks should lend the amount of an insurance premium to persons desiring fire or casualty coverage. After deducting a small down payment, a bank would collect the balance periodically over the life of the policy, charging 6% interest on the diminishing unpaid balances. As collateral for the loan, the insured would assign to the bank his claim to the "short rate" return premium which the insurance company was obliged to pay according to a fixed schedule whenever the policy was canceled. The insured also gave the bank power to cancel the policy 10 days after any default on the scheduled payments.

Under the Stevens Plan, in case of default on the note, the bank could claim a return premium slightly in excess of the balance due on the loan, and thus the risk of loss was negligible. Mr. Stevens, designer of the plan, had prepared and copyrighted tables to show, according to duration and size of policy, the

[1] The forms used in the Stevens Plan were copyrighted in 1938 by Allan C. Stevens.

amount, the down payment, and the periodic installment for all normally encountered combinations of loans. He had also prepared forms of note and assignment which set up satisfactorily the details of a loan regardless of the number of policies against which it might be made. Mr. Stevens charged an installation fee of $25 for the forms.

A major reason why banks had not previously entered this field of financing was the difficulty of obtaining an assignment, of rights under a policy, which could be used without objection by the insurance company in case the lender defaulted. The officers of the Aurora Bank had had one unfortunate experience in such a case several years before. The Stevens Plan claimed to have overcome that difficulty. The terms of its note and assignment had been agreed to by over 200 insurance companies, who had deposited with a custodian bank identical letters approving the plan and its detailed forms. Most of the other companies had not objected to the form of note and assignment, and probably would accept obligations under it, if properly notified. Early in 1939 Mr. Stevens negotiated with certain companies which he hoped to add to the list of those who approved the plan. This list contained the names of the major stock companies in the field but no large mutual company. Mutual companies did not approve of plans for financing premiums on their policies, as they preferred to do the financing themselves.

The appeal of the plan lay not only in buying insurance with small periodic payments, but also in reducing its total cost to the purchaser. Insurance companies made substantial reductions of premiums if policies were taken out for longer periods than one year: three-year policies were sold at two and one-half times the one-year rate; and five-year policies at four times the one-year rate. By using the Stevens Plan, a person could take advantage of a part of these savings without being required to make a large payment in any one year, for the 6% interest cost on the diminishing balance of the loan would be considerably less than the amount saved.

Those of the directors of the Aurora Bank who had proposed the adoption of the plan claimed that its advantages to persons carrying fire or casualty coverage were so great that very little promotional activity would be necessary to develop a satisfactory volume. The bank's own customers could be circularized by mail, and others could be reached through their insurance agents with whom the bank would cooperate.

19. UNDERWRITING

MELHAM NATIONAL BANK

SUBSCRIBING AND BIDDING FOR NEW ISSUES OF UNITED STATES SECURITIES[1]

In the spring and early summer of 1930, the decline in customer demand for credit released a substantial part of the Melham National Bank's funds. The bank, a medium-sized New York institution, had by June, 1930, not only liquidated its indebtedness at the New York Federal Reserve Bank, but had built up its long-term bond account to an amount which the directors considered a maximum in view of prevailing conditions in the bond market. Consequently, as further funds were released, they were invested in commercial paper, bankers' acceptances, call loans, and Treasury notes and certificates of indebtedness. Weekly

EXHIBIT 1

Open-market Rates in New York City*

1930, Week Ending	Prevailing Rate on			Average Rate on Call Loans		Average Yield on	
	Prime Commercial Paper 4–6 Months	Prime Bankers' Acceptances 90 Days	Time Loans 90 Days	New	Renewal	U. S. Treasury Notes and Certificates 3–6 Months	Treasury Bonds†
June 7	3½–3¾	2⅛–2⅜	3¼	3.00	3.00	1.97	3.39
June 14	3½–3¾	2⅛	3–3¼	2.81	2.90	1.78	3.37
June 21	3½–3¾	2⅛	2¾–3	2.56	2.50	1.98	3.37
June 28	3¼–3½	1⅞–2	2½–2¾	2.02	2.20	1.83	3.37
July 5	3¼–3½	1⅞	2¾	2.54	2.38	1.87	3.36
July 12	3–3½	1⅞	2½–2¾	2.48	2.40	1.85	3.36

* Source: *Federal Reserve Bulletin*, July and August, 1930, pp. 419 and 490.

† Three issues—3¾%, 4%, and 4¼%; yields calculated on the basis of last redemption dates—1956, 1954, and 1952. [If these issues selling at a premium should be called at par before maturity, the yields would be somewhat less than those here shown.]

[1] See: York, J. Y., Jr., "The Position of the Commercial Bank in the Origination and Distribution of Securities," *Harvard Business Review*, July, 1929, pp. 445–452; Towbin, Belmont, "Treasury Bills," *Harvard Business Review*, July, 1933, pp. 507–511; Kirshman, J. E., *Principles of Investment*, third edition, Ch. XXXII; Love, R. A., *Federal Financing;* Willoughby, W. F., *Financial Condition and Operations of the National Government 1921–1930*, pp. 203–210.

EXHIBIT 2

Treasury Department Circular Offering Certificates of Indebtedness, Series TJ—1931*

The Secretary of the Treasury, under the authority of the act approved September 24, 1917, as amended, offers for subscription, at par and accrued interest, through the Federal reserve banks, Treasury certificates of indebtedness of Series TJ—1931, dated and bearing interest from June 16, 1930, payable June 15, 1931, with interest at the rate of 2⅞% per annum, payable on a semiannual basis.

Applications will be received at the Federal reserve banks.

Bearer certificates will be issued in denominations of $500, $1,000, $5,000, $10,000, and $100,000. The certificates will have two interest coupons attached, payable December 15, 1930, and June 15, 1931.

The certificates of said series shall be exempt, both as to principal and interest, from all taxation (except estate and inheritance taxes) now or hereafter imposed by the United States, any State, or any of the possessions of the United States, or by any local taxing authority.

The certificates of this series will be accepted at par during such time and under such rules and regulations as shall be prescribed or approved by the Secretary of the Treasury, in payment of income and profits taxes payable at the maturity of the certificates. The certificates of this series will be acceptable to secure deposits of public moneys, but will not bear the circulation privilege.

The right is reserved to reject any subscription and to allot less than the amount of certificates applied for and to close the subscriptions at any time without notice. The Secretary of the Treasury also reserves the right to make allotment in full upon applications for smaller amounts, to make reduced allotments upon, or to reject, applications for larger amounts, and to make classified allotments and allotments upon a graduated scale; and his action in these respects will be final. Allotment notices will be sent out promptly upon allotment, and the basis of the allotment will be publicly announced.

Payment at par and accrued interest for certificates allotted must be made on or before June 16, 1930, or on later allotment. After allotment and upon payment, Federal reserve banks may issue interim receipts pending delivery of the definitive certificates. Any qualified depositary will be permitted to make payment by credit for certificates allotted to it for itself and its customers up to any amount for which it shall be qualified in excess of existing deposits, when so notified by the Federal reserve bank of its district. Treasury certificates of indebtedness of Series TJ—1930, maturing June 16, 1930, will be accepted at par, in payment for any certificates of the series now offered which shall be subscribed for and allotted, with an adjustment of the interest accrued, if any, on the certificates of the series so paid for.

As fiscal agents of the United States, Federal reserve banks are authorized and requested to receive subscriptions and to make allotments on the basis and up to the amounts indicated by the Secretary of the Treasury to the Federal reserve banks of the respective districts.

A. W. Mellon,
Secretary of the Treasury

* *Annual Report of the Secretary of the Treasury*, 1930, pp. 294–295.

data for rates on these forms of investment between June 7 and July 12, 1930, are given in Exhibit 1.[1]

On June 7 the Secretary of the Treasury offered a new issue of certificates of indebtedness, maturing June 15, 1931. This

[1] For comparable rates in other periods, see Appendix III.

offering is described in Exhibit 2. Exhibits 3, 4, and 5 present information regarding the two next-preceding offerings of certificates. Exhibit 6 contains a list of all the then outstanding short-term obligations of the United States Government which were available for investment.

At this time the Melham National Bank had approximately $1,000,000 available for investment, without taking into account $40,000 of Treasury certificates, maturing June 16, 1930. The Melham National Bank had been designated by the Treasury Department as a depositary for public moneys to an amount

EXHIBIT 3

Offerings of Treasury Certificates of Indebtedness*

Issue	Date Offered	Date Issued	Maturity	Rate	Total Subscriptions Received	Total Subscriptions Allotted
TS—1930	Dec. 6, 1929	Dec. 16	Sept. 15, 1930	$3\frac{1}{8}$	$ 722,552,500	$351,640,500
TD—1930	March 7, 1930	March 15	Dec. 15, 1930	$3\frac{1}{4}$	1,290,990,000	483,341,000

* Source: *Op. cit.*, pp. 283–285, 289–291.

EXHIBIT 4

Deposit Calls by the Secretary of the Treasury*

TS—1930		TD—1930	
Date	Per Cent Called	Date	Per Cent Called
December 24, 1929	8	March 21, 1930	15
December 31, 1929	12	March 28, 1930	3
January 3, 1930	20	April 1, 1930	6
January 7, 1930	30	April 4, 1930	9
January 10, 1930	12.5	April 8, 1930	12.5
January 21, 1930	10	April 11, 1930	4
February 4, 1930	50	April 16, 1930	15
February 7, 1930	50	April 18, 1930	10
February 13, 1930	50	April 22, 1930	15
March 4, 1930	Balance	April 25, 1930	10
		April 29, 1930	4
		May 2, 1930	33.33
		May 6, 1930	20
		June 3, 1930	45
		June 6, 1930	30
		July 1, 1930	Balance

* In each case the per cents called are based not on the original deposit, but upon the balance in the deposit account after previous calls have been paid.

EXHIBIT 5

Quotations on Certificates of Indebtedness*

TS—1930			TD—1930		
Date	Bid	Asked	Date	Bid	Asked
December 11, 1929	99–30	100	March 13, 1930	100	100–2
December 12, 1929	99–28	100	March 14, 1930	100	100–2
December 13, 1929	99–28	99–30	March 15, 1930	100	100–2
December 14, 1929	99–28	99–30	March 17, 1930	100	100–3
December 16, 1929	99–28	99–30	March 18, 1930	100	100–2
December 17, 1929	99–28	99–30	March 19, 1930	100	100–2
December 18, 1929	99–27	99–30	March 20, 1930	100–2	100–4
December 19, 1929	99–26	99–29	March 21, 1930	100–7	100–10
December 20, 1929	99–26	99–29	March 22, 1930	100–5	100–9
December 21, 1929	99–27	99–29	March 24, 1930	100–5	100–8
December 23, 1929	99–27	99–29	March 25, 1930	100–3	100–6
December 24, 1929	99–27	99–29	March 26, 1930	100–2	100–5
December 25, 1929	.....	......	March 27, 1930	100	100–3
December 26, 1929	99–27	99–29	March 28, 1930	100	100–3

* Source: *New York Times*. Figures after dash are thirty-seconds.

EXHIBIT 6

Short-term Obligations of the United States, Outstanding and Available for Investment, as of May 31, 1930*

Treasury Notes		
3½ % Series A, 1930–32, Maturing Mar. 15, 1932	$779,079,850	
3½ % Series B, 1930–32, Maturing Sept. 15, 1932	500,311,700	
3½ % Series C, 1930–32, Maturing Dec. 15, 1932	451,723,950	
		$1,731,115,500
Treasury Certificates		
4⅞ % Series TJ—1930, Maturing June 16, 1930	$549,707,500	
3⅛ % Series TS—1930, Maturing Sept. 15, 1930	351,640,500	
3¼ % Series TD—1930, Maturing Dec. 15, 1930	483,341,000	
		1,384,689,000
Treasury Bills (Maturity Value)		
Maturing July 14, 1930	$ 51,316,000	
Maturing Aug. 18, 1930	104,600,000	
		155,916,000
Total		$3,271,720,500

* Source: *Commercial and Financial Chronicle*, June 14, 1930, p. 4185.

not in excess of $500,000, and on June 7, 1930, United States deposits held were $116,000.[1]

[1] In June, 1930, banks as depositaries for public moneys were paying interest at the rate of 2% per annum on daily balances and were not required to hold reserves against such deposits. Since 1935, interest has not been paid, although reserves have been required, as for other demand deposits. See *Digest of Rulings of the Board of Governors of the Federal Reserve System from 1914 to October 1, 1937*, pp. 504, 506. Since January 29, 1934, certificates of indebtedness have been used by the Secretary of the Treasury only in special issues, and not for ordinary financing.

One month later, on July 7, 1930, the policy of the Melham National Bank in regard to the investment of surplus funds remained unchanged, and available funds amounted to $600,000. On this date the Treasury Department invited tenders for a new

EXHIBIT 7

Treasury Department Notice Inviting Tenders for Treasury Bills Dated July 14, 1930*

The Secretary of the Treasury gives notice that tenders are invited for Treasury bills to the amount of $50,000,000, or thereabouts. The Treasury bills will be sold on a discount basis to the highest bidders. Tenders will be received at the Federal reserve banks, or the branches thereof, up to 2 o'clock P.M., eastern standard time, on July 10, 1930. Tenders will not be received at the Treasury Department, Washington.

The Treasury bills will be dated July 14, 1930, and will mature on September 15, 1930, and on the maturity date the face amount will be payable without interest. They will be issued in bearer form only, and in amounts or denominations of $1,000, $10,000, and $100,000 (maturity value).

Particular attention is invited to the fact that by the act of Congress approved June 17, 1930, Treasury bills were given an additional tax exemption feature. That act provides that any gain from the sale or other disposition of Treasury bills issued after June 17, 1930, shall be exempt from all taxation, except estate or inheritance taxes, and that no loss from the sale or other disposition thereof shall be allowed as a deduction, or otherwise recognized, for the purposes of any tax now or hereafter imposed by the United States or any of its possessions. Accordingly, these Treasury bills will be exempt, as to principal and interest, and any gain from the sale or other disposition thereof will also be exempt, from all taxation, except estate or inheritance taxes.

It is urged that tenders be made on the printed forms and forwarded in the special envelopes which will be supplied by the Federal reserve banks or branches upon application therefor.

No tender for an amount less than $1,000 will be considered. Each tender must be in multiples of $1,000. The price offered must be expressed on the basis of 100, with not more than three decimal places, *e.g.*, 99.125. Fractions must not be used.

Tenders will be accepted without cash deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by a deposit of 10 per cent of the face amount of Treasury bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Immediately after the closing hour for receipt of tenders on July 10, 1930, all tenders received at the Federal reserve banks or branches thereof up to the closing hour will be opened and public announcement of the acceptable prices will follow as soon as possible thereafter, probably on the following morning. The Secretary of the Treasury expressly reserves the right to reject any or all tenders or parts of tenders, and to allot less than the amount applied for, and his action in any such respect shall be final. Those submitting tenders will be advised of the acceptance or rejection thereof. Payment at the price offered for Treasury bills allotted must be made at the Federal reserve banks in cash or other immediately available funds on July 14, 1930.

* Source: *Annual Report of the Secretary of the Treasury*, 1930, pp. 296–297.

issue of Treasury bills.[1] The notice announcing the terms of this issue is contained in Exhibit 7. Data regarding previous issues of Treasury bills are presented in Exhibit 8. The Melham National Bank never had invested any of its funds in Government obligations of this type.

EXHIBIT 8

Offerings of Treasury Bills*

Date Offered	Maturity	Amount Applied For	Bids Accepted	Highest Bid—Annual Basis	Lowest Bid Accepted—Annual Basis	Average Annual Rate
Dec. 10, 1929	March 17, 1930	$223,901,000	$100,000,000	2¾	3⅜	3.25
Feb. 11, 1930	May 19, 1930	186,183,000	56,108,000	3	3½	3.30
April 7, 1930	July 14, 1930	132,377,000	51,316,000	2¾	3	2.93
May 12, 1930	Aug. 18, 1930	275,674,000	104,600,000	2⅜	2⅝	2.54

* Source: *Op. cit.*, pp. 285–288, 291–294.

For what reasons, if any, should these two forms of short-term investment have been preferred to the others available at the same time?

What action should the Melham National Bank have taken in regard to: (*a*) subscriptions to the June 7 offering of Treasury certificates of indebtedness, and (*b*) bids on the July 7 issue of Treasury bills?

Assuming a decision was made to subscribe, should the Melham National Bank hold to maturity or sell its allotment of the certificates of indebtedness?

Assuming a decision to sell, when would it probably be most profitable to do so?

What factors determine the amount and the profitability of the deposit accounts obtained from the United States Government?

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[1] The first issue of Treasury bills was announced on December 10, 1929. According to the law, they may be issued with maturities up to 12 months, but it is not expected that the maturity of such bills will exceed 3 months, and the bills are intended to supplement rather than supplant the longer-term Treasury certificates of indebtedness. Treasury bills are not sold at par with an interest rate fixed by the Treasury, but at a discount rate fixed by subscribers through competitive bidding.

20. ORIGINATING F.H.A. MORTGAGES

TAYLOR BANK

ORIGINATION AND SALE OF F.H.A. MORTGAGES BY A COMMERCIAL BANK[1]

The board of directors of the Taylor Bank had decided not to enter the F.H.A. insured mortgage field either as originators or as investors, but recurrent requests from customers for such accommodation, together with occasional loss of accounts as well as mortgage business, led the officers to reconsider their decision in the spring of 1940. The directors were unwilling to change their position as to investment in F.H.A. mortgages but thought that by originating and selling them the bank would avoid the loss of other business and prevent the development of unfavorable criticism on the part of customers. In addition, the bank could probably make a profit on the transactions without investing permanently in such mortgages.

To become an originator of F.H.A. insured mortgages, the bank would have to be approved by the F.H.A. as a mortgagee, and the loans would have to be made in conformity with the F.H.A. standards of home construction, location, mortgage pattern, and credit status of the borrower.[2] Mortgages could be granted for not more than 80% of the appraised value of the property, but in no case for more than $16,000, repayment to be achieved within 20 years. Two exceptions were made. If the amount of the mortgage did not exceed $8,600 and the property value was appraised at more than $6,000, loans could be made up to 90% of the first $6,000 of property value plus 80% of the remainder.

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[1] See: Bimson, W. R., "Casting Up Our Insured Loan Accounts," Lockwood, F. S., "How Our Bank Handles Insured Mortgages," Lovelace, D. D., "Our Bank's Insured Mortgage Lending," *Insured Mortgage Portfolio*, November, 1936, p. 3ff., December, 1936, p. 5ff., September, 1937, p. 7ff., respectively; F.H.A., *Mutual Mortgage Insurance*, revised July 1, 1939. For F.H.A. mortgages as investments, see case of Frye National Bank, *supra*.

[2] For the techniques used by the F.H.A. to determine whether or not mortgages are eligible for insurance under Title II of the National Housing Act, see F.H.A., *Underwriting Manual*.

A mortgage of not over $5,400 on a single family, owner-occupied, recently constructed residence could be issued up to 90% of the appraised value and could be repaid over a 25-year period. Payments would be made by the mortgagor in approximately equal monthly installments covering interest at not more than 5% per annum, amortization, and one-twelfth of each of the following annual charges: mortgage insurance premium, taxes, and insurance. The mortgagee could also charge the mortgagor the amount of the F.H.A. appraisal fee and an initial service charge to reimburse itself for the cost of closing the transaction. Depending upon the size of the original principal of the mortgage, the former fee would amount to from $10 to $48, and the latter, depending on additional circumstances, from $20 to $400. The mortgage, when ready, would be sent to the F.H.A. for its investigation and approval.

An active and wide market was thought to exist for such mortgages.[1] Among known purchasers of F.H.A. mortgages were commercial banks, savings banks, life and fire insurance companies, building and loan associations, trust companies, foundations, the Reconstruction Finance Corporation Mortgage Company, the Federal National Mortgage Association, and privately financed national mortgage associations.

Profits could be obtained in two ways. First, the existing interest rates on insured mortgages in the district of the Taylor Bank ranged from 4¼ to 4¾%, whereas purchasers were willing to accept an investment return somewhat smaller than the mortgage interest less a service charge. Sales could be made at prices of around $102 to $103½ per $100 of mortgage face value, thus giving a profit to the originator on the turnover. Second, by retaining the servicing function on the mortgages sold, the bank

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[1] From 1935 through 1938, commercial banks originated and had accepted, for insurance under Section 203 of Title II of the National Housing Act, insured mortgages on homes amounting to $862,183,638, or 56.4% of the total origination of such mortgages in the country. Sales of premium-paying mortgages (mortgages covering houses to be constructed cannot become premium-paying mortgages until construction is completed free of liens; in certain other circumstances, periods of from 60 days to 6 months may elapse between the date of issue of commitment to insure and that of recording the mortgage as a premium-paying mortgage) by commercial banks during the same period were $164,209,468, or 19% of those originated by them, and 43.3% of the total volume of such sales by all types of originators. Net premium-paying mortgages held on December 31, 1938, in commercial bank portfolios amounted to $619,535,147, or 51 7% of the total outstandings of $1,198,674,505. As protection, the F.H.A. mutual mortgage insurance fund on that date amounted to $22,637,623, or 1.9% of outstandings.

could collect regularly from the purchasers[1] compensation of from ½% to ¾% per annum on the remaining unpaid principal balances. Since the remaining principal would be reduced annually by amortization, the bank's fee would be reduced each successive year, so that eventually the annual dollar fee might not cover the year's servicing costs. Although, technically, the holder of the F.H.A. mortgage is responsible for its servicing, the bank could not expect to drop the servicing function on any mortgage as soon as it became unprofitable to handle; rather, a bank acting as agent would probably continue the servicing in order to maintain its goodwill among those who might become mortgage buyers sometime in the future. A reserve should be set up from earnings in the early years, therefore, to provide for the costs in the later period when collections would not cover costs.

Incidentally, banks servicing F.H.A. mortgages would expect to derive some patronage for other departments as mortgagors developed the habit of making their monthly payments at the office of the servicing banks. On the other hand, some ill will might be developed because of foreclosures. In this connection the question of whether or not the bank should make its own investigation was important. If reliance were placed on the F.H.A., some of the directors argued, a large number of foreclosures might result, a circumstance which might not only injure the bank's reputation as a seller of mortgages, but also hurt the bank in its other activities. Other members of the board admitted that the quality of the mortgages sold by them would probably be better if they made their own investigations but emphasized the facts that such a policy would also entail considerable annoyance to customers who would have to undergo two investigations, and that it would involve additional cost.

Finally, in determining whether or not the origination and sale of F.H.A. mortgages would be profitable, it was necessary to estimate the cost of performing the originating service and to compare it with the income available through its performance. In the opinion of an expert in F.H.A. mortgages, with whom a representative of the bank had talked, origination of about $2,000,000 a year in principal value of mortgages was necessary to make

[1] Prior to February 15, 1938, a servicing fee of not over ½% could be collected from the mortgagor in addition to interest. Since then, any servicing fee had to be deducted from the interest paid. The Federal National Mortgage Association and the Reconstruction Finance Corporation Mortgage Company allowed a service fee of three-fourths of 1%.

operations profitable. To discover whether such an amount was obtainable and how long it would take to reach that volume, the bank would have to estimate the annual mortgage volume available in its district and the proportion of that market which it could secure. Records of the past, the existing conditions in the district, and the experience of any similar sections with F.H.A. mortgages would be helpful in forming this judgment. The area to be served consisted of a manufacturing town of about 150,000 population, surrounded by several suburbs, beyond which lay a district of small farms. Competition would come mainly from a mutual savings bank and from a local mortgage company. While both of these originated F.H.A. mortgages, only the latter was actively soliciting them at that time.

21. TRUST DEPARTMENTS

SCHUYLER NATIONAL BANK

DEVELOPMENT OF A TRUST DEPARTMENT[1]

Although the Schuyler National Bank had been granted trust powers in 1923, no effort was made to develop the bank's trust business until November, 1928, when a policy of expansion was instituted. The Schuyler National Bank was one of the oldest and most conservative banks in New York City, having acquired deposits totaling more than $48,000,000. The business of the bank was chiefly commercial, but the personal accounts of wealthy individuals were important, and the bank had safe deposit and foreign departments. There was no organization for the sale of securities or mortgages, and it was the firm conviction of the directors that the bank should not engage in these activities. Bonds purchased for the bank's bond account were mainly short-term issues, of which governments and municipals made up the largest part.

Prior to November, 1928, the trust department consisted of one trust officer, his secretary, and two clerks. The activities of the department had included answering inquiries in regard to investments, preparing income tax returns, and acting as custodian of customers' securities. Much of this work was performed without remuneration. In addition, there were agency and trust accounts which in November, 1928, amounted to $1,200,000. The bank had not acted as executor or administrator of estates, nor had it accepted any form of corporate trust business. Except for a series of newspaper advertisements and a small descriptive booklet, no attempt had been made to solicit new business. Since no business had been directly traceable to the

[1] See: Herrick, Clay, *Trust Departments in Banks and Trust Companies;* Kirkbride, Sterrett, and Willis, *The Modern Trust Company*, sixth edition; Smith, J. G., *The Development of Trust Companies in the United States;* American Bankers Association, Trust Division, *Guide to Trust Fees with Recommended Cost Accounting System;* Remington, J. W., *Trust Business in the Future* (Research Council, American Bankers Association).

For the trust powers of national banks, see: Title 12, §248(k), U.S.C., 1934 edition, and Title 12, §248(k), Title 26, §169, U.S.C., 1934 edition, Supplement IV; Regulations of the Board of Governors of the Federal Reserve System, Regulation F, *Federal Reserve Bulletin*, May, 1936, pp. 327–336; January, 1938, pp. 10–13; December, 1939, p. 1054; June, 1940, pp. 502–509. For legal effects of consolidation upon trusts, see footnote citations, Ebersole, J. F., *op. cit.*, first edition, p. 448, or second edition, p. 279.

advertisements and the booklet, the bank had not continued their use. Salary costs of operating the trust department amounted to about $11,000 a year, while gross income had fluctuated between $2,000 and $3,000.

There were several reasons for the decision of the directors to expand the trust department. It was believed that this department could be developed into an important source of income. Other banks had developed profitable trust departments, and, in view of the increased general interest in the care and conservation of property, it was felt that the Schuyler National Bank was neglecting an opportunity in not capitalizing its position and contacts. Furthermore, there was the danger that the bank would lose some of its present customers. In one case, a valuable customer had named a trust company as his executor and later had transferred his personal and business accounts from the Schuyler National Bank to the larger bank, which was equipped to offer complete trust and financial service.

The Schuyler National Bank was in a strategic position for the development of trust business. Its customers, in general, were prosperous and conservative, and its directors were men not only of wealth but of considerable social standing. Consequently, it was expected that the new business campaign would yield excellent results. Two strong sales arguments were available. In the first place, the bank had no securities for sale, so that the prospective customer would be sure of impartial action on all investments.[1] In the second place, the Schuyler National Bank was a relatively small institution, and it was planned to emphasize personal contact with senior trust officers as a reason for selecting the Schuyler National Bank in preference to one of the larger New York banks. It was a common complaint that only the most influential customers were able to confer with senior officers in the large banks, and that less important customers were relegated to junior officers of less experience and possibly inferior judgment.

The development of the trust department was expected to react favorably on the business of other departments. Deposits would be increased both by the temporary deposit of trust department funds and by the deposits of individuals who were not customers but who would find it convenient to open accounts after they had appointed the bank as trustee or agent. Customers

[1] See case of Seneca Trust Company, Ebersole, J. F., *op. cit.*, first edition, pp. 485–489; second edition, pp. 312–316.

who were traveling abroad, and for whom the trust department was acting as agent, would purchase travelers' checks and letters of credit from the foreign department; the commercial business would benefit from the new contacts, and it was the general opinion that a strong and growing trust department would enhance the prestige of the entire bank.

The staff of the trust department was enlarged by the addition of the following men: a legally trained and experienced trust officer, who was secured from the trust department of one of the larger banks; two assistant trust officers, one of whom was capable of managing the office routine; a financial statistician with sufficient executive ability to organize and manage a small statistical department; and one new business solicitor. The secretarial and clerical staff necessarily was increased. The annual salary cost of the increased department was estimated at $36,000. This did not include any charge for space, heat, light, or administrative overhead, for which the trust department was not to be debited. The facts that ample quarters were available on the main banking floor, that the trust department made no charge for investment and other advice given to the bank's customers, and that the bank as a whole would benefit from the expansion of the department were considered sufficient reasons to warrant the absorption of the trust department's normal share of the overhead costs. It was planned that the trust department's staff would be increased gradually, and that at the end of five years the costs of operating the department would be approximately $70,000 a year.

The new business campaign, as planned, included both advertising and personal solicitation, but by far the greater emphasis was placed upon the latter method. The directors believed that efforts should be concentrated upon securing executorships, since this was the most profitable form of trust work.[1] Individuals who

[1] Compensation for trust services is not uniform in the different states. In most states fees for executors, guardians, testamentary trustees, etc., are fixed by statute. Other fees are competitive. In the State of New York the statutory fees (Laws of New York, 1923, Ch. 649, Sec. 285) are as follows:

For Executors or Administrators.—Fee figured on total value of estate including income received during administration of estate:

5% on the first	$ 2,000
2½% on the next	20,000
1½% on the next	28,000
2% on all amounts over	50,000

(Footnote continued on next page.)

appointed a bank as executor also frequently named the bank as trustee in their wills. To obtain such new accounts, a series of advertisements, stressing the importance of making a will and the superiority of a bank over an individual as executor, was run in two of the leading newspapers.[1] Booklets emphasizing the same points and describing the bank's trust work in detail were placed in the racks on the check desks, in the coupon booths in the safe deposit department, and in the customers' monthly statements. Personal solicitation of new business was carefully planned. No individual was considered a prospect unless he appeared to be worth at least $100,000; a list of prospects was built up by the analysis of the records of the credit department, where one of the trust department's clerks was placed. When all available information in regard to a prospect had been secured, a memorandum was submitted to the senior trust officer in charge of new business. He checked the information, added to it, if possible, and endeavored to obtain an introduction to the prospect through the directors, officers, or customers of the bank. Actual solicitation was done by the senior trust officer, by one of the two assistant trust officers, and by the full-time solicitor.[2]

For Testamentary Trustees, Guardians, Etc.—Fee figured on both the principal and the annual income, the income fee being taken yearly, and the principal fee being payable one-half when the trust is accepted and the other half when it is terminated:

5% on the first	$ 2,000
2½% on the next	20,000
1½% on the next	28,000
2% on all income over	50,000

Competitive fees in New York City, although subject to variation, are reasonably well standardized. For the more common services the fees are as follows:
Living Trusts.

1% of principal at acceptance
1% of principal at termination
2% of annual income

Agency Accounts.—Custodianship of customers' securities plus collection of income and preparation of income tax returns:

1/10 of 1% per annum of the income on the first. ...	$ 500,000 of principal
1/15 of 1% per annum of the income on the second....	500,000 of principal
1/20 of 1% per annum of the income on all amounts over	1,000,000 of principal

Custodianship plus Investment Management.—This is not as common in New York City as in other localities. The charge varies, but approximates that on living trusts.

[1] The advertising of the trust functions probably has been more fully developed than that of any other phase of banking activities. For information on this subject, see: Long and Farwell, *Fundamentals of Financial Advertising;* MacGregor, T. D., *Bank and Trust Company Advertising.*

[2] See the case of Manville National Bank, *supra.*

The administration of estates, although profitable, did not result in immediate income, so that a part of the emphasis was placed on securing living trusts, agency accounts, and a limited amount of corporate trust business. Living trusts of less than $50,000 were refused, and especial care was taken to avoid both those trusts which presented difficult problems in investment management and those in which it appeared that the donors, beneficiaries, or co-trustees might prove troublesome. The Schuyler National Bank had no facilities for handling real estate, but, if a small proportion of an otherwise desirable trust was made up of real estate, the trust was accepted, and an arrangement for the management of the real estate was made with an independent agent.

Two committees supervised and determined the investment of estate and trust funds. One was a subcommittee, made up of the two senior trust officers and the statistician; the other was the trust committee, composed of seven directors, including the president and the vice president of the bank.

Corporate trust work was limited to acting as registrar and transfer agent, since the directors did not believe that a small bank, which did no underwriting of securities, was in a position to act as trustee under corporate mortgages or in the other fiduciary capacities common to the larger banking institutions.[1] The directors of the Schuyler National Bank believed that their plan of developing the trust department, although slow, would obtain the best results in the long run. If developmental expenses were considered an operating cost, the directors did not expect that the trust department as a whole would show a profit within less than 10 years. After that time, however, a substantial income was anticipated.

What would a survey probably show as to the existence of trust business that could be performed by the trust department of the Schuyler National Bank?

What factors are to be considered in deciding whether to offer *all* kinds of trust service when opening a trust department?

Criticize: (*a*) the limitations and restrictions imposed upon the acceptance of trust business, (*b*) the emphasis upon securing

[1] For information on the corporate trust department, consult Page and Gates, *The Work of Corporate Trust Departments*.

appointments as executor, and (*c*) the two sales arguments stressed.

Should a trust department be viewed as an advertising device for other departments, or as an independent profit-producer?

Wherein does the solicitation of trust business differ from that of commercial banking? Can advertising be used more effectively by the trust department than by other departments? What appeals and media should be used in trust advertising? How much should be spent on such advertising, and how can the direct results of such expenditures be traced?

Are the statutory and customary fees of trustees and trust companies sufficiently large to cover the costs of the highest quality of investment management?

PLANDOR TRUST & SAFE DEPOSIT COMPANY

INVESTMENT OF A TRUST FUND[1]

For approximately five years prior to April, 1931, Mrs. J. L. Delano of Boston had been a client of one of the largest investment counsel firms. This organization, Dow and Jenkins, gave advice and recommendations regarding the purchase and sale of securities, but did not attend to any of the details of management, such as collection of income and the preparation of income tax returns. Because of her desire to be relieved of these details, and her wish to provide for the conservation of her property after her death, Mrs. Delano, in April, 1931, created a living trust with the Plandor Trust & Safe Deposit Company of Boston, Massachusetts.[2] The trust agreement between Mrs. Delano and the trust company is reproduced in Exhibit 1. The securities which were transferred by Mrs. Delano to the trustee are listed in Schedule A of the same exhibit.

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[1] References: Smith, J. G., *The Development of Trust Companies in the United States;* Loring, A. P., *A Trustee's Handbook*, fourth edition; Stephenson, G. T., *Living Trusts Including Insurance Trusts*, second edition; Conyngton, Knapp, and Pinkerton, *Wills, Estates, and Trusts;* Scott, A. W., "Deviation from the Terms of a Trust," *Harvard Law Review*, May, 1931, pp. 1025–1048.

[2] The following excerpt from the case of Kimball v. Whitney (1919), 123 N. E. 665, gives the Massachusetts law regarding the investment of trust funds:

"The rule of law in this commonwealth governing the conduct of trustees in the investment of the principal of their funds was stated in these words in 1830 in Harvard College v. Amory, 9 Pick. 446, 461: 'All that can be required of a trustee to invest is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested.' Good faith and sound discretion, as these terms ought to be understood by reasonable men of good judgment, were thus made the standard by which the conduct of trustees is to be measured. That is a comprehensive principle. It is wide in its scope. It is not limited to a particular time or a special neighborhood. It is general and inclusive, so that while remaining itself fixed, it may continue to be a safe guide under new financial institutions and business customs, changed commercial methods and practices, altered monetary usages and investment combinations. It avoids the inflexibility of definite classification of securities, it disregards the optimism of the promoter, and eschews the exuberance of the speculator. It holds fast to common sense and depends on practical experience. It is susceptible of being adapted to whatever conditions may arise in the evolution of society and the progress of civilization. Although more liberal to investing trustees than the law of some states and countries, it has frequently been reaffirmed and never doubted in this jurisdiction."

EXHIBIT 1

Trust Agreement and List of Securities

I, Jane Lincoln Delano, of Boston, Suffolk County, Massachusetts (hereinafter called "the Donor") hereby sell, transfer, and deliver to the Plandor Trust & Safe Deposit Company, a Massachusetts corporation (hereinafter called "the Trustee") the property described in the schedule hereto annexed marked "A," to hold, manage, and invest the same and any additions that may from time to time be made thereto (hereinafter called "the trust fund") in trust for the following purposes:

1. So long as the Donor is living, the Trustee shall pay to her, not less often than quarterly, the net income of the trust fund.

2. The Trustee shall also pay to the Donor from time to time such portions of the principal of the trust fund as she may request in writing; provided, however, that no payments of principal shall be made unless approved in writing by one of the Donor's children.

The words, "the Donor's children," as used in this instrument mean the Donor's son, Everett Saylor Delano of Wellesley, Massachusetts, and the Donor's daughter, Patricia Delano Maywick of Evanston, Illinois. The said children are sometimes hereinafter referred to individually as a "child of the Donor."

3. Upon the death of the Donor, the Trustee shall pay over, free of all trusts, to each child of the Donor who is then living, the sum of Twenty Thousand Dollars ($20,000), and shall pay over, free from all trusts, to the issue then living of each deceased child of the Donor the sum of Twenty Thousand Dollars ($20,000), such issue to take by right of representation. All such payments shall be made from the principal of the trust fund.

4. From and after the death of the Donor, the Trustee shall pay over the net income of the balance of the trust fund, as from time to time constituted, to the issue of the Donor in equal shares by right of representation.

5. From and after the death of the Donor, the Trustee shall pay to the Donor's children out of the principal of the trust funds such amounts, if any, as the Trustee in its uncontrolled discretion may deem necessary or advisable for their comfortable support and maintenance, respectively.

6. When, after the death of the Donor, each child shall have attained the age of 45 years or shall have died, the Trustee shall pay over the principal of the trust fund, free of all trusts, to the then living issue of the Donor in equal shares by right of representation, or in default of such issue, the Trustee shall pay over the principal to those persons who would take property under the laws of the Commonwealth of Massachusetts, had she then died intestate.

7. The Trustee, in addition to and not in limitation of all common law and statutory authority, shall have power with regard to both real and personal property in the trust fund and any part thereof, to mortgage, to lease with or without option to purchase, and to sell in whole or in part at public or at private sale without approval of any court and without liability upon any person dealing with the Trustee to see to the application of any money or other property delivered to it; to exchange property for other property; to invest and reinvest in securities or properties although of a kind or in an amount which ordinarily would not be considered suitable for a trust investment, and to purchase or retain any securities, the purchase or retention of which are requested by the Donor; to keep any or all securities or other property in the name of some other person or corporation or in its own name without disclosing its fiduciary capacity; to determine what shall be charged or credited to income and what to principal, notwithstanding any determination by the courts, and specifically but without limitation, to make such determination in regard to stock and cash dividends, rights and all other receipts in respect of the ownership of stock, and to purchase or retain stocks which pay dividends in whole or in part otherwise than in cash, and in its discretion to treat such dividends in whole or in part as income; to determine who are the distributees hereunder and the proportions in which they shall take; to make payments of principal or income

EXHIBIT 1. (*Continued*)

Schedule A

Security	Amount	Closing Prices 4/22/31*	Dividend per Share
Common Stocks	Shares		
American Smelting & Refining......	50	42	$4.00
American Telephone & Telegraph...	45	184⅞	9.00
Atchison, Topeka & Santa Fe.......	30	166	10.00
Borden Company..................	38	69⅝	3.00†
California Packing Corporation......	60	32	2.00
Columbia Gas & Electric...........	50	32	2.00
Continental Insurance.............	100	42	2.40
Corn Products Refining............	40	69½	3.50‡
Du Pont...........	40	84⅝	4.00
Electric Bond & Share.............	100	42	In stock, 6%
General Electric..................	200	42⅛	1.60
General Motors...................	130	39⅞	3.00
International Harvester............	80	48	2.50
International Telephone............	100	27¼	2.00
New York Central................	44	99½	6.00
North American Company..........	300	68⅜	In stock, 10%
Otis Elevator....................	80	44⅛	2.50
Proctor & Gamble................	120	67	2.40
Southern Pacific..................	90	89½	6.00
Standard Oil of New Jersey........	500	37¾	2.00‡
Texas Gulf Sulphur...............	30	41	4.00
Underwood-Elliott-Fisher..........	60	54⅛	5.00
Union Carbide & Carbon...........	100	57⅛	2.60
Union Pacific....................	40	161	10.00
Bonds	Par Value		
American Rolling Mill 4½'s, 1933...	$10,000	97⅞	....
Appalachian Power 5's, 1941........	5,000	102½§	....
Brooklyn & Manhattan 6's, 1968....	5,000	102	....
Gatineau Power 5's, 1956..........	6,000	91¾	....
Edison Electric of Boston 5's, 1933..	10,000	103⅛	....
Erie 5's, 1967....................	4,000	73½	....
Great Northern 7's, 1936...........	7,000	110½	....
Koppers Gas Coke 5's, 1947........	6,000	102	....
Kresge Foundation 6's, 1936........	6,000	102½	....
New Orleans Public Service 5's, 1952	3,000	93	....
New York Edison 5's, 1944.........	7,000	106¼	....
Northern States Power 4's, 1931	11,000	100½§	....
Rio Grande Western 4's, 1949......	8,000	83⅜	....
United States Rubber 5's, 1947	6,000	68⅛	....
Virgina Public Service 5½'s, 1946...	10,000	95¼	....

* Source: *New York Times*, April 23, 1931.
† Plus 3 % in stock.
‡ Partly extra.
§ Bid.

direct to and otherwise to deal with minors hereunder as though they were of full age; to make distributions or divisions of principal hereunder in property in kind at values determined by it; to decide whether or not to make deductions from income for depreciation, obsolescence, amortization or waste and, if so, in what amount; to pay, compromise, or contest any claim or other matter

EXHIBIT 1. (*Continued*)

directly or indirectly affecting this fund; to employ counsel for any of the above or other purposes and to determine whether or not to act upon his advice; and generally to do all things in relation to the trust fund which the Donor could do if living and this trust had not been executed. All such divisions and decisions made by the Trustee in good faith shall be conclusive on all parties in interest. The Trustee shall receive reasonable compensation for its services hereunder.

8. The Donor reserves the right at any time (but only with the same approval by the Donor's children as is required by the provisions of paragraph 2 hereof) to revoke this trust in whole or in part by an instrument in writing, delivered to the Trustee. If the agreement is revoked in its entirety the revocation shall take place upon the delivery of the instrument in writing to the Trustee, but any amendment or any partial revocation shall take effect only when consented to in writing by the Trustee.

9. The interest of any beneficiary hereunder, either as to income or principal, shall not be anticipated, alienated or in any other manner assigned by such beneficiary and shall not be subject to any legal process, bankruptcy proceedings or the interference or control of creditors or others.

10. The Trustee shall each year render an account of its administration of the trust to the person or persons of full age entitled at the time to receive the income thereof. Such person's or persons' written approval of such an account shall, as to all matters and transactions stated therein or shown thereby, be final and binding upon all persons (whether in being or not) who are then or may thereafter become entitled to share in either the principal or the income of the trust.

11. The Trustee may resign as Trustee from the trusts hereby created at any time by giving thirty (30) days' written notice delivered personally or by registered mail to the Donor, or, if the Donor has deceased, to the beneficiaries then entitled to the income. The person or a majority of the persons of full age to whom notice is thus given may appoint a successor Trustee by a writing endorsed hereon or annexed hereto, or, if no such appointment is made within the said thirty (30) days, the resigning Trustee itself shall so appoint a successor. Any succeeding Trustee shall have all the powers conferred upon the original Trustee.

Mrs. Delano was a widow 67 years old and was dependent upon the income from her investments. Her annual expenditures averaged about $12,000. She had two children, a son and a daughter, both of whom were married. The son, aged 34, was a junior partner in one of the smaller brokerage houses in Boston, while the daughter, aged 29, lived in Evanston, Illinois, where her husband was a professor of biology. There were three grandchildren.

The Plandor Trust & Safe Deposit Company handled all types of trust business, and in April, 1931, its personal trust account business amounted in the aggregate to over $180,000,000. Management of the trust investments was in the hands of an investment committee, which was composed of five directors of the bank. For the guidance of the trust officers who were in direct charge of the trust accounts, a set of regulations had been drawn up. These regulations are given in Exhibit 2. In theory, the investment committee passed on all trust investments, but, in

order to eliminate the large amount of detail and time which would have been required to put this theory into practice, the investment committee had prepared a list of securities which were approved for trust fund investments. This list was watched carefully and revised frequently by additions or eliminations. When a security was eliminated from the list, the trust officer who had charge of trust investments refrained from additional purchases of the security, and, if the reason for striking it from the list was sufficiently important, the security was sold at the first favorable opportunity from the trusts in which it was lodged. In making trust investments, the trust officers were permitted to buy securities on the approved list without consulting the trust committee. The approval of such purchases by the committee was then obtained, as a matter of form. The approved list, however, was not all-inclusive, as many securities which were suitable for trust investments did not appear on the list because of the fact that they seldom appeared on the market and, therefore, were not readily purchasable. The list was effective for one date only, since it was subject to change at any time in accordance with current developments. Two members of the investment committee were always available for consultation with the trust officers, and these two directors and any one of the trust officers constituted an informal subcommittee. Approval of this subcommittee was necessary for certain investments.

EXHIBIT 2

Regulations for the Guidance of Plandor Trust & Safe Deposit Company Trust Officers

Read trust instrument for authorizations or restrictions, as its provisions will take precedence over any other consideration.

In the absence of special provisions, the laws of the state under which the trust is established, will govern. Therefore, if it is not a Massachusetts trust, consider the legal limitations.

If it is a Massachusetts trust, or if, being a trust of another state we may invest in our discretion, either by law or by authority of the instrument, investments are to be selected from the list of those authorized by the trust committee.

This selection should be varied as between yields—not all 5% nor yet all 7% securities; also as between classes, for example, railroads, industrials, power and light companies, telephone securities, municipals, etc., and real estate and real estate mortgages; and also to some degree as between localities, as, for example, different sections of the country. As a rule, 25% invested in any single class, or in special cases less, will be a fair limit.

The amount of a single security (considering bonds and stock of the same company as a single unit) should be limited as follows:

In trusts or $5,000 or less, each unit not over $1,000.

In trusts of $5,000 to $50,000, each unit not over 10%.

EXHIBIT 2. (*Continued*)

In trusts of $50,000 to $100,000, each unit not over $5,000.
In trusts of $100,000 to $2,000,000, each unit not over 5%.
In trusts of $2,000,000 or over, each unit not over 2½%.

If a trust is wasting, or terminates on a given date, see that the maturities of bonds purchased correspond with the cash requirements. If the life tenant is very old, and cash will be needed in distribution at termination, invest in short-time rather than long-time securities. This will probably give a larger income and provide cash when needed.

For investing the proceeds of maturing bonds, or of securities sold because of an excess proportion in the trust, try to select an investment yielding at least as much income, and, when feasible, with the same income dates.

Invest promptly, and, in the case of the proceeds of small items sold because too small to be worth carrying, immediately.

Massachusetts mortgages, while helpful to a certain extent in all trusts (because introducing an additional class of security of practically nonfluctuating value), are of greater use in trusts for Massachusetts beneficiaries than for foreign, because of being tax free in Massachusetts. In times of high money rates, the short maturity of mortgages operates against their desirability in comparison with longer-term bonds.

In buying municipals, bear in mind that taxables always yield more than the nontaxables for trusts with foreign beneficiaries, and often for Massachusetts beneficiaries. Also in buying several issues for one trust, see that a fair distribution of locality is obtained.

As between two bonds giving the same yield according to the bond tables, the one bearing the higher rate and selling at or near par should be preferred to the one bearing the lower rate and costing less. The increment in value at maturity, which is taken into consideration in the bond tables, goes to the remainderman, the life tenant only receiving the rate as figured on a dividend basis. In the case of an accumulating trust, this distinction may be ignored.

In sales, do not be influenced too much by book values. As a rule, when one sells low, he can buy low. Selling low-grade securities, however, for reinvestment, presents a problem. An individual could reinvest in a better, but still a low-grade security. A trustee must reinvest in his regular high-grade securities. This, as a rule, results in a safer principal but reduced income.

In trusts, as a rule, do not buy or sell stocks just before the dividend comes off unless offset by a sale or purchase of stock with nearly similar dividend dates. In buying them when the full dividend is in the price, the life tenant receives unearned income at the expense of the remainderman, and in selling the remainderman benefits at the expense of the life tenant.

In buying common stocks, avoid those of companies which pay dividends wholly or largely in stock. Stock dividends are considered as principal and accrue to the remainderman, the life tenant receiving only the cash dividends.

In buying bonds, select varying maturities. Then in case of the sudden termination of the trust or unexpected need for cash, there will usually be something that can be sold at or near par.

Where the number of remaindermen is known, it is helpful to keep the number of bonds in a given unit a multiple of the number of parts into which the trust ultimately is to be divided. This is especially true in guardianships of several wards.

What classes and types of securities should be on the approved list? How frequently should the approved list be revised?

When securities are removed from the approved list, should holdings of such securities then be sold from all trust accounts?

In what respects, if any, could the regulations in regard to diversification of investments be improved?

22. SAVINGS DEPOSITS AND DEBENTURES

THE PEOPLES STATE BANK

"FREEZING" DEPOSITS BY THE USE OF DEBENTURES

When The Peoples State Bank of St. Joseph, Michigan, commenced business on January 9, 1932, the city was provided with banking facilities for the first time in over three months, for the two banks in the city had merged in 1929 and failed in the latter part of September, 1931. Although it occupied the premises of one of them, the new bank had no connection with either of the former institutions. Instead, it raised new capital and recruited officers from out of town. Its financial history from 1932 to 1938 is shown in Exhibit 1.

EXHIBIT 1

Financial Statements of The Peoples State Bank as of December 31, 1932, to 1938
(000 omitted)

	1932	1933	1934	1935	1936	1937	1938
Assets							
Cash and Cash Items	$ 283	$ 336	$ 621	$ 638	$1,351	$ 775	$ 669
U. S. Government Bonds*	640	734	1,097	1,324	1,027	1,045	1,397
Other Bonds*	103	66	20	......	167	252	226
Loans and Discounts	39	29	46	75	113	96	123
Mortgage Loans	......	......	......	40	61	116	127
Banking House	......	......	......	......	......	40	47
Fixtures	3	5	5	5	4	4	
Total Assets	$1,068	$1,170	$1,789	$2,082	$2,723	$2,688	$2,589
Liabilities							
Demand Deposits	$ 716	$ 765	$1,189	$1,170	$1,592	$1,614	$1,544
Savings Deposits	285	333	476	774	966	905	836
Cashier's Checks	2	4	2	4	1	1	......
Capital Stock	50	50	65	80	80	100	100
Surplus	10	10	28	28	28	30	65
Reserves	5	8	29	26	56	38	43
Total Liabilities	$1,068	$1,170	$1,789	$2,082	$2,723	$2,688	$2,589

* At cost.

In St. Joseph, Michigan, and its neighboring city, Benton Harbor, there were industrial plants employing approximately 7,000 people with annual payrolls of $7,500,000. The retail stores in these cities enjoyed patronage from a large agricultural district in the southwestern part of the State of Michigan, where the principal economic activity was the growing of peaches and other

fruits. This activity had been quite profitable, and except for the worst years of the depression of the 1930's, seemed able to exist as a consistently successful business. By 1936 interest was exhibited in expanding the areas under cultivation.

The Peoples State Bank thought that a desirable source of earnings could be developed in mortgage loans for periods up to five years, amortized to maturity. The managers of the bank, however, were unwilling to make such loans with funds provided by commercial deposits or against the usual type of savings deposits, since experience indicated that both types of obligations were subject to rapid withdrawal in times of stress, whereas mortgage loans were not subject to call.

EXHIBIT 2

CERTIFICATE OF DEPOSIT
Not Subject to Check

THE PEOPLES STATE BANK No. TC-
71-231 OF ST. JOSEPH
St. Joseph, Michigan $100.00

19

__________ has deposited in this bank
ONE HUNDRED DOLLARS
Payable to the order of self__________
five years after date, upon the return of this certificate properly endorsed, with interest at the rate of 2% per annum, payable semi-annually.
NO INTEREST AFTER MATURITY.

The bank is prohibited from paying this deposit in whole or in part before its maturity and from paying interest after maturity.

President Cashier

THIS CERTIFICATE MUST BE PRESENTED FOR INTEREST ENDORSEMENTS

The managers of the bank also contemplated the reduction of the interest rate on savings deposits from 2% to 1% per annum, since the yields on high-grade bonds were very low. The final conclusion reached was to reduce the interest rate on savings deposits to 1% per annum but to make available to savings depositors negotiable 5-year certificates of deposit, issued in denominations of $100 and $500, and bearing an interest rate of 2%, payable semiannually. The form of the proposed certificates is shown in Exhibit 2. The bank would endeavor to "make a market" for the certificates but would not pay them before maturity.

Coincidentally, the bank advertised its willingness to make mortgage loans subject to amortization provisions, with five-year maturities, and at 6%, but with discounts for prompt payment

and fulfillment of covenants that reduced the effective rates to borrowers to from 4% to 5½%.

Announcements of these changes appeared late in 1936. By the end of 1937, the bank had received many applications for mortgage loans and had made some loans to the most satisfactory applicants. The management was disappointed, however, over the failure of the savings depositors to transfer their funds into certificates of deposit. Almost no certificates were sold. A compensating surprise, however, was the fact that few savings depositors withdrew their accounts, despite the reduction in the interest rate.

In reviewing the results, the officers decided that more certificates would have been sold if the rate paid had been slightly higher than that paid by the postal savings banks. When the rate paid upon the certificates was originally set, the officers had expected the postal savings bank rate to be reduced.

TUXBURY BANK

APPRAISING GOVERNMENT COMPETITION FOR SAVINGS FUNDS BY THE ISSUANCE OF UNITED STATES SAVINGS BONDS[1]

As a result of the increasing volume of savings being invested in United States savings bonds, the officers of the Tuxbury Bank were considering, in the spring of 1940, a change in the rate of interest offered upon savings deposits. Any decision appeared to depend upon two factors: first, the rate that would hold and attract savings deposits;[2] and second, the rate that could be obtained upon investments and loans over and above the cost of administering both the loans and investments and the savings deposits. Studies previously made by the bank indicated that opportunities available for making loans and investments would enable the bank to pay as high as 2% upon savings deposits. Consequently, the problem was simply one of ascertaining the relative attractiveness, to present or potential depositors, of a savings account with interest at 2% or less, or a United States savings bond, the important features of which are presented in Exhibits 1, 2, 3, and 4.

The officers decided, therefore, to compare the gain, from the standpoint of the savings depositor, of placing money in the bank at 2%, compounded semiannually, with the gain obtained from investing an equal amount in United States savings bonds. The relative advantage to the depositors, as calculated, is presented in Exhibit 5. A prolonged debate arose as to whether the factor of rate was really the most significant one. It was suggested by some that the depositor with a savings account in the

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[1] Beginning April 1, 1940, the Secretary of the Treasury limited the purchase of these bonds to individuals and thereby prevented corporations from acquiring more. From March 1, 1935, through October 31, 1939, banks purchased 9.61% of the total sales, according to a form letter of the Secretary of the Treasury, dated December 27, 1939.

[2] Effective since January 1, 1936, the maximum rate of interest payable by member banks on savings deposits has been 2½%, compounded quarterly. For a tabulation of maximum rates payable by member banks since November 1, 1933, on savings and other time deposits, see *Federal Reserve Bulletin*, March, 1940, p. 214. For the text of Regulation Q and the supplement thereto in force during the spring of 1940, see *Federal Reserve Bulletin*, December, 1935, pp. 862–867.

EXHIBIT 1

Excerpts from the Offering Circular for United States Savings Bonds, Series D*

3. United States Savings Bonds . . . will be issued only in registered form, in denominations of $25, $50, $100, $500, and $1,000 (maturity values) . . . All such savings bonds will be dated as of the first day of the month in which the issue price (or the application accompanied by remittance to cover the issue price) is received by an authorized agent; they will mature and be payable 10 years from such issue date. Savings bonds may not be called for redemption by the Secretary of the Treasury prior to maturity, but they may be redeemed prior to maturity (but not within 60 days after the issue date) at the owner's option, in accordance with the table of redemption values appearing at the end of this circular. Partial redemption of savings bonds of denominations other than $25 (maturity value) will be permitted in accordance with regulations prescribed from time to time by the Secretary of the Treasury (see paragraph 14). No interest will be paid on savings bonds, but they increase in redemption value at the end of the first year from issue date, and at the end of each successive half-year period thereafter until their maturity, when the face amount becomes payable. The increment in value is payable only upon redemption of the bond. A table of redemption values for each bond appears on the face thereof. The purchase price of savings bonds has been fixed so as to afford an investment yield of about 2.9 per cent per annum compounded semiannually if the bonds are held to maturity; if the owner exercises his option to redeem a bond prior to maturity the investment yield will be less . . .

4. The savings bonds will not be transferable, and will be payable only to the owner named thereon, except in case of death or disability of the owner or as otherwise specifically provided in regulations prescribed from time to time by the Secretary of the Treasury (see paragraph 14), and in any event only in accordance with such regulations. Accordingly they may not be sold and may not be hypothecated as collateral for a loan . . .

5. Each of the bonds issued hereunder will be entitled to such exemption from taxation as may be authorized by the law in effect on its issue date. Under the law in effect on the date of this circular (December 15, 1938) the bonds are exempt, both as to principal and interest, from all taxation now or hereafter imposed by the United States, any State, or any of the possessions of the United States or by any local taxing authority, except (*a*) estate or inheritance taxes, or gift taxes, and (*b*) graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States, upon the income or profits of individuals, partnerships, associations, or corporations; the interest on an amount of bonds authorized by the Second Liberty Bond Act, approved September 24, 1917, as amended, the principal of which does not exceed in the aggregate $5,000, owned by any individual, partnership, association, or corporation, shall be exempt from the taxes provided for in clause (*b*) above; and further, for the purposes of determining taxes and tax exemptions, the increment in value of savings bonds represented by the difference between the price paid and the redemption value received (whether at or before maturity) shall be considered as interest.

. . . .

7. Section 22 of the Second Liberty Bond Act, as amended, provides that it shall not be lawful for any one person at any one time to hold savings bonds issued during any one calendar year in an aggregate amount exceeding $10,000 maturity value . . .

. . . .

10. A savings bond will be held in safekeeping without charge by the Secretary of the Treasury if the holder so desires, and in such connection the facilities of the Federal Reserve banks as fiscal agents of the United States will be utilized . . .

. . . .

14. All savings bonds issued pursuant to this circular shall be subject to regulations prescribed from time to time by the Secretary of the Treasury. Such regulations may require, among other things, reasonable notice in case of

EXHIBIT 1. (*Continued*)

presentation of savings bonds for redemption prior to maturity. The present regulations governing savings bonds issued hereunder are contained in Treasury Department Circular No. 530, Second Revision, dated December 15, 1938.

* Source: Treasury Department Circular (No. 596) of December 15, 1938.

EXHIBIT 2

Redemption Values, Approximate Yields, and Approximate Sacrificed Yields of a $75 Investment in United States Savings Bonds, as Computed for the Beginning and Ending Days of the Several Half-Year Periods

Periods of Redemption after Date of Issue of Bond (Years)	Redemption Value	Approximate Yield if Redeemed (%)		Approximate Sacrificed Yield to Maturity if Redeemed (%)	
		First Day	Last Day	First Day	Last Day
2/12– 1/2	$ 75	0.00	0.00	*	*
1/2 –1	75	0.00	0.00	3.05	3.23
1 –1 1/2	76	1.33	0.88	3.07	3.26
1 1/2 –2	77	1.76	1.35	3.10	3.30
2 –2 1/2	78	1.97	1.57	3.13	3.34
2 1/2 –3	79	2.09	1.74	3.17	3.40
3 –3 1/2	80	2.16	1.85	3.22	3.49
3 1/2 –4	81	2.21	1.91	3.27	3.54
4 –4 1/2	82	2.24	1.99	3.34	3.64
4 1/2 –5	83	2.26	2.04	3.42	3.76
5 –5 1/2	84	2.28	2.05	3.51	3.92
5 1/2 –6	85	2.29	2.09	3.65	4.11
6 –6 1/2	86	2.29	2.11	3.81	4.36
6 1/2 –7	87	2.30	2.12	4.01	4.69
7 –7 1/2	88	2.30	2.13	4.31	5.20
7 1/2 –8	90	2.45	2.29	4.27	5.33
8 –8 1/2	92	2.57	2.41	4.22	5.63
8 1/2 –9	94	2.67	2.52	4.17	6.29
9 –9 1/2	96	2.76	2.62	4.13	8.33
9 1/2 –10	98	2.84	2.68	4.08	744.89
Maturity 10	100	2.90†			

* Not computed.
† Failure to redeem promptly would reduce the yield to somewhat less than 2.90.

bank was not so much concerned with the rate of return as with the convenience of the location, the ready availability of the funds on demand, and the ability to deposit or withdraw sums as small as one dollar.

One of the officers suggested that the bank ought to be issuing debentures with a fixed maturity, and that the desirability of such obligations should also be canvassed as a possible form of competition for the depositors seeking a higher rate of interest.

EXHIBIT 3

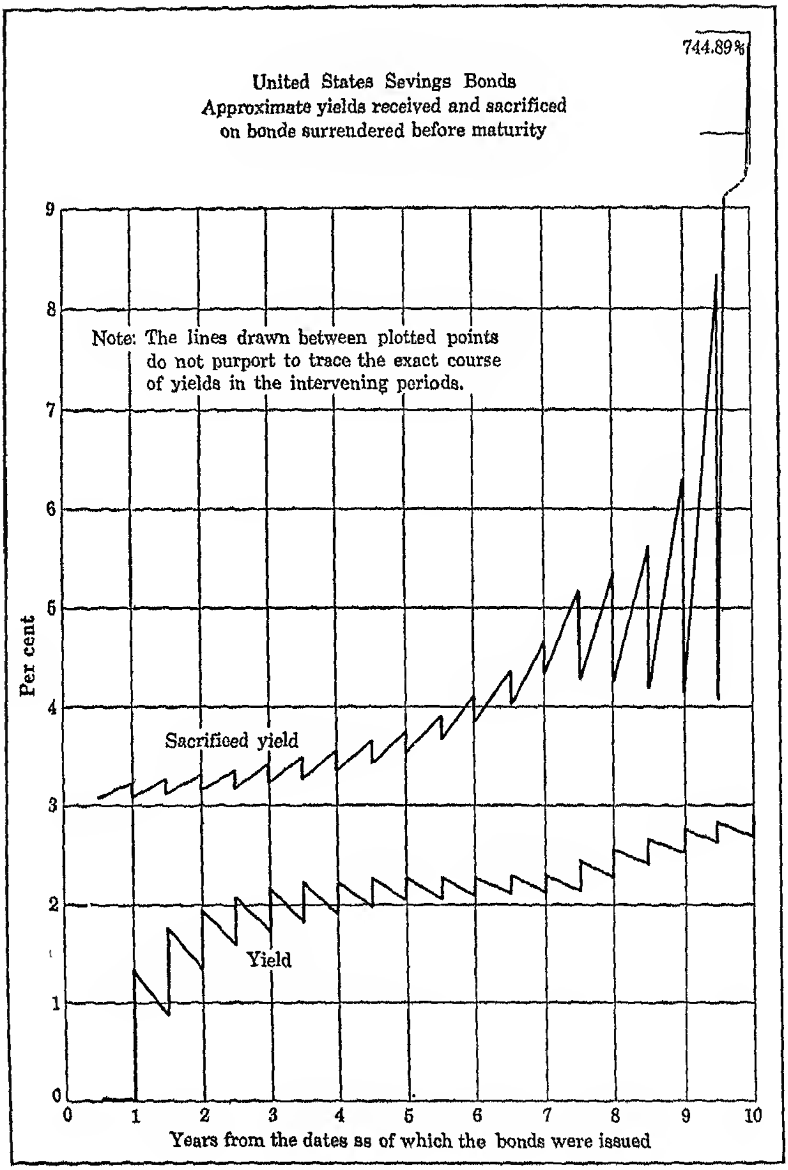
United States Savings Bonds
Approximate yields received and sacrificed
on bonds surrendered before maturity
744.89%
Note: The lines drawn between plotted points
do not purport to trace the exact course
of yields in the intervening periods.
Sacrificed yield
Yield
Per cent
0
1
2
3
4
5
6
7
8
9
10
Years from the dates as of which the bonds were issued

EXHIBIT 4

United States Savings Bond Yields to the Next Increment Date Sacrificed by Redemption at Selected Times in the Preceding Half-Year Period

Time of Redemption				
Time Elapsed after Date of Issue of Bond (In Years and Months)		Months before Next Increment Date	Redemption Value	Approximate Yield per Annum to Next Increment Date Sacrificed by Redemption
0	0	12	0	*
	1	11	0	*
	2	10	75	1.60
	3	9		1.78
	4	8		2.00
	5	7		2.29
	6	6		2.67
	7	5		3.20
	8	4		4.00
	9	3		5.33
	10	2		8.00
	11	1		16.00
	11½	½		32.00
1	1	5	76	3.16
	2	4		3.95
	3	3		5.26
	4	2		7.89
	5	1		15.79
	5½	½		31.58
1	7	5	77	3.12
	8	4		3.90
	9	3		5.19
	10	2		7.79
	11	1		15.58
	11½	½		31.17
2	1	5	78	3.08
	2	4		3.85
	3	3		5.13
	4	2		7.69
	5	1		15.38
	5½	½		30.77
2	7	5	79	3.04
	8	4		3.80
	9	3		5.06
	10	2		7.59
	11	1		15.19
	11½	½		30.38
3	1	5	80	3.00
	2	4		3.75
	3	3		5.00
	4	2		7.50
	5	1		15.00
	5½	½		30.00

EXHIBIT 4. (*Continued*)

Time of Redemption				
Time Elapsed after Date of Issue of Bond (In Years and Months)		Months before Next Increment Date	Redemption Value	Approximate Yield per Annum to Next Increment Date Sacrificed by Redemption
3	7	5	81	2.96
	8	4		3.70
	9	3		4.94
	10	2		7.41
	11	1		14.81
	11½	½		29.63
4	1	5	82	2.93
	2	4		3.66
	3	3		4.88
	4	2		7.32
	5	1		14.63
	5½	½		29.27
4	7	5	83	2.89
	8	4		3.61
	9	3		4.82
	10	2		7.23
	11	1		14.46
	11½	½		28.92
5	1	5	84	2.86
	2	4		3.57
	3	3		4.76
	4	2		7.14
	5	1		14.29
	5½	½		28.57
5	7	5	85	2.82
	8	4		3.53
	9	3		4.71
	10	2		7.06
	11	1		14.12
	11½	½		28.24
6	1	5	86	2.79
	2	4		3.49
	3	3		4.65
	4	2		6.98
	5	1		13.95
	5½	½		27.91
6	7	5	87	2.76
	8	4		3.45
	9	3		4.60
	10	2		6.90
	11	1		13.79
	11½	½		27.59

EXHIBIT 4. (*Continued*)

Time of Redemption: Time Elapsed after Date of Issue of Bond (In Years and Months)	Time of Redemption: Months before Next Increment Date	Redemption Value	Approximate Yield per Annum to Next Increment Date Sacrificed by Redemption
7 1	5	88	5.46
2	4		6.82
3	3		9.09
4	2		13.64
5	1		27.28
5½	½		54.55
7 7	5	90	5.33
8	4		6.67
9	3		8.89
10	2		13.33
11	1		26.67
11½	½		53.33
8 1	5	92	5.22
2	4		6.52
3	3		8.70
4	2		13.04
5	1		26.09
5½	½		52.17
8 7	5	94	5.11
8	4		6.38
9	3		8.51
10	2		12.77
11	1		25.53
11½	½		51.06
9 1	5	96	5.00
2	4		6.25
3	3		8.33
4	2		12.50
5	1		25.00
5½	½		50.00
9 7	5	98	4.90
8	4		6.12
9	3		8.16
10	2		12.24
11	1		24.49
11½	½		48.98

* Cannot be redeemed.

EXHIBIT 5

Cash Surrender Values of $75 Deposited in a Savings Account at 2% Interest Compounded Semiannually or Used to Purchase a United States Savings Bond at Selected Periods

Years from Date of Investment	Cash Surrender Value*	
	Bank Savings Account	United States Savings Bonds
1/12	$75.00	$ 0.00
2/12	75.00	75.00
½	75.75	75.00
1	76.51	76.00
1½	77.27	77.00
2	78.05	78.00
2½	78.83	79.00
3	79.61	80.00
3½	80.41	81.00
4	81.21	82.00
4½	82.03	83.00
5	82.85	84.00
5½	83.68	85.00
6	84.51	86.00
6½	85.36	87.00
7	86.21	88.00
7½	87.07	90.00
8	87.94	92.00
8½	88.82	94.00
9	89.71	96.00
9½	90.61	98.00
10	91.51	100.00

* Based on the assumption that each investment is made on the first of the month.

What different purposes may lead to the establishment of savings accounts by depositors? What differences, if any, may be found in their susceptibility to different forms of competition?

Assuming that the bank's earnings would permit it to pay 2½%, would its competitive strength be substantially greater if it offered that rate?

Would a savings bank find more severe competition from the postal savings banks than from United States savings bonds?

23. FOREIGN EXCHANGE

W. O. LYONS AND COMPANY

FINANCING A WOOL IMPORTER[1]

On January 14, 1931, W. O. Lyons and Company, wool dealers, applied to the foreign department of the Sutcliffe National Bank of New York City for a $50,000 letter of credit to finance imports from Argentina. The company submitted its balance sheet, as of December 31, 1930, shown in Exhibit 1, at the time it applied for this financing. Although W. O. Lyons and Company had been a customer of the Sutcliffe National Bank for a number of years, Mr. Ferris, the manager of the foreign department, determined to reexamine the firm's credit standing before agreeing to grant any further accommodation. This decision was not due entirely to the receipt of a new statement, since it was the policy of the foreign department to look into the affairs of customers each time that new financing was requested.[2]

W. O. Lyons and Company did not furnish the bank with sales or profits figures. However, the company advised Mr. Ferris that the reduction in its surplus account on the 1930 statement was due almost entirely to operating losses, and that it had paid no dividends during the year. Mr. Ferris knew that the company had practically the same volume of business with another New York bank that it had with the Sutcliffe National Bank and esti-

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[1] References for use in this and subsequent cases involving foreign exchange: Escher, Franklin, *Elements of Foreign Exchange*, ninth edition; Furniss, E. S., *Foreign Exchange*, especially pp. 205–215; Harr and Harris, *Banking Theory and Practice*, second edition; Whitaker, A. C., *Foreign Exchange*, second edition; Willis and Steiner, *Federal Reserve Banking Practice;* Edwards, G. W., *International Trade Finance;* Westerfield, R. B., *Banking Principles and Practice*, revised printing; Djörup, Christian, *Foreign Exchange Accounting;* Waid, Wilbert, *Bank Credits and Acceptances;* Keynes, J. M., *Monetary Reform*, pp. 125–151 (on futures in foreign exchange); Finkelstein, H. N., *Legal Aspects of Commercial Letters of Credit.*

[2] Regardless of whether or not the Sutcliffe National Bank was secured by documents giving title to the merchandise in transit, it did acceptance financing only for those firms which enjoyed an excellent credit standing. Even in the case of staples, considerable loss was likely to be suffered if the bank were forced to take possession of goods and sell them in order to reimburse itself for default on the part of a customer. The factors of cost and trouble involved in disposing of commodity collateral were also important.

mated, on the basis of the deposit figures shown in Exhibit 1, that its gross sales had been approximately $1,400,000 in 1929, and $1,250,000 in 1930. In view of the adverse conditions which had prevailed in the textile industry during 1930 and the weakness in wool prices[1] over the same period, he felt that the company had done well not to suffer a larger shrinkage in sales or a larger deficit. The reductions shown in current debt and book value of inventory and the establishment of reserves were also in the firm's favor. Before agreeing to do the proposed financing, however, Mr. Ferris consulted with the credit manager of the Sutcliffe National Bank regarding the company's 1930 statement. The credit manager stated that W. O. Lyons and Company's unsecured note for $50,000 would fall due on February 15, 1931, and that he saw no reason why a renewal should not be made if the company requested it.

Although Mr. Ferris felt that W. O. Lyons and Company was showing poor judgment by increasing its inventory during the off season when stocks should be declining in preparation for the spring clip in the United States, he believed that the next important movement in wool prices would be upward.[2] Furthermore, he knew that the company practically had an assured outlet, through two substantial mills, for the type of wool which it wished to import, and that it had a reputation for contracting only such obligations as it was able to discharge. Consequently, the Sutcliffe National Bank took favorable action on the application of W. O. Lyons and Company, reproduced in Exhibit 2, and issued an

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[1] For the situation in wool prices, consider Dun's composite wool prices for 25 grades, in cents per pound:

	January	February	March	April	May	June	July	August	September	October	November	December
1929	....	....	....	....	69.1	66 1	64.6	64.8	64.9	62.9	61.5	58.9
1930	56.7	54.3	52.8	51.3	50.0	49.4	49.4	48.7	48.7	47.9	46.9	....

Source: Standard Statistics Company, *Statistical Bulletin, December Supplement, 1930.*

[2] The situation was described in the United States Department of Agriculture, Bureau of Agricultural Economics, *Weekly Review of the Wool Market*, week ending January 10, 1931, as follows: "Developments in the wool market . . . have been mostly of a constructive nature. Buyers were more numerous, and they were bidding on offerings more freely than for many weeks. Offers were quite frequently rejected, and some houses are holding their wools at figures higher than currently quoted prices, thus giving the market a slightly firmer tone . . . The volume of sales was moderately larger than during the previous week."

EXHIBIT 1

Financial Statements of W. O. Lyons and Company, as of December 31, 1929, and 1930

	1929	1930
Assets		
Cash	$ 19,844	$ 21,644
Notes Receivable	7,885	15,335
Accounts Receivable	212,892	90,782
Merchandise	279,603	185,890
Current Assets	$520,224	$313,651
Machinery and Equipment	9,168	6,098
Investments, Stocks and Bonds	40,620	42,620
Prepayments and Accruals	29	472
Total Assets	$570,041	$362,841
Liabilities		
Notes Payable, Banks	$200,000	$ 50,000
Accounts Payable	22,224	14,486
Acceptances under Letters of Credit	140,345	107,675
Accruals	514	1,528
Reserves, Taxes and Bad Debts	....	3,454
Current Liabilities	$363,083	$177,143
Reserve, Depreciation	....	2,697
Capital Stock	150,000	150,000
Surplus	56,958	33,001
Total Liabilities	$570,041	$362,841
Letters of Credit Outstanding with Sutcliffe National Bank	$ 57,000	$ 36,000
Total Deposits During Year in Sutcliffe National Bank	704,100	628,400
Bradstreet's Credit Rating	$125–200,000 1st	$125–200,000 1st
Dun's Credit Rating	$125–200,000 High	$125–200,000 High

irrevocable letter of credit, shown in Exhibit 3, in favor of Julio Fernandez y Compania, an exporter in Buenos Aires.

Immediately after issuing this letter of credit, the Sutcliffe National Bank cabled its correspondent in Buenos Aires stating the number and terms of the credit. The correspondent bank then advised Julio Fernandez y Compania that the credit had been opened in its favor.

EXHIBIT 2

Sutcliffe National Bank, Application for Letter of Credit

Sutcliffe National Bank
New York City

New York, *January 14, 1931*

Dear Sirs:

We beg to request that you issue a Documentary Letter of Credit in any of your usual forms, as follows:

Amount......*$50,000*..
Favor of......*Julio Fernandez y Compania* ....
Account of......*W. O. Lyons and Company*..........................
Available by drafts at......*90 days sight*... ....
Covering invoice value of......*Wool in the grease*................
Shipment to......*New York*......and to be effected by..............
February 28, 1931..
Documents required. ....*Commercial invoice, consular invoice, ocean bills of lading, and insurance certificate*...............................
Insurance to be effected by......*Shipper*..........................
Credit to be opened by......*Cable*.................................

The Letter of Credit is to be subject to your usual terms and conditions; we agree to pay you the amount of each acceptance under it in cash at or prior to the maturity of such acceptance, and we hereby authorize you to charge our account with you with any and all amounts that may, at any time or times, be due from us to you hereunder.

Neither you nor your correspondents shall be responsible for any loss arising from any difference in quality or character of merchandise imported under this credit from that stipulated and expressed in the invoice accompanying the drafts, nor for the correctness or genuineness of the documents, nor for delay or deviation from instructions in regard to shipment.

Your charge for commission under such credit shall be 1½% per annum for such part as shall be used.

You are further requested to surrender to *W. O. Lyons and Company* or their nominees, from time to time, any merchandise shipped under this credit under your usual form of trust receipt.

This Letter of Credit can only be withdrawn or canceled with the consent of all parties interested.

Signature of Applicant *W. O. Lyons and Company*

After preparing a shipment of wool in accordance with instructions received from W. O. Lyons and Company, Julio Fernandez y Compania inquired at several banks in Buenos Aires regarding the rate of exchange that could be realized on a dollar draft on the Sutcliffe National Bank. The Banco Territorial quoted the highest rate, 143.57 gold centavos per dollar. On that basis Julio Fernandez y Compania drew a draft for $50,000 in favor of the Banco Territorial, receiving in return the paper money equivalent of 71,785 gold pesos. The Banco Territorial then inspected the documents which were to accompany the shipment, to be sure they were in order. It attached these documents to the draft and mailed the resulting documentary bill to the Peddie Trust Company, its New York correspondent.

EXHIBIT 3

Sutcliffe National Bank, Letter of Credit

Credit *#137,248* New York, *January 16, 1931*

Julio Fernandez y Compania
Buenos Aires, Argentina

Dear Sirs:

At the request and for the account of *W. O. Lyons and Company* we hereby authorize you to value on

Sutcliffe National Bank, New York City

at...... *Ninety (90) days sight* for a sum not exceeding a total of.... ..*Fifty thousand dollars ($50,000)*..
accompanied by......*Commercial invoice, consular invoice, ocean*..........
............................*bills of lading, and insurance certificate*......
representing......*Cost, insurance, and freight on shipment of*..............
......*wool in the grease from Buenos Aires, Argentina, to New York*......
Insurance......*Marine insurance to be effected by the shipper*.............

Bills of lading for such shipment must be made out to the order of

Sutcliffe National Bank, New York City

We hereby agree with the drawer, endorsers, and all bona fide holders that all drafts issued by virtue of this credit, and in accordance with its terms above stipulated, shall meet with due honor upon presentation at the office of the Sutcliffe National Bank, New York City, if drawn and negotiated by *February 28, 1931.*

Sutcliffe National Bank
by *Logan Ferris, Vice President.*

The Peddie Trust Company received the draft on February 2, and immediately presented it at the Sutcliffe National Bank for acceptance. After it had been accepted, the Peddie Trust Company surrendered the documents attached to the draft to the Sutcliffe National Bank, discounted the draft itself in the open market at the rate of 1⅝%, and credited the account of the Banco Territorial with the proceeds. The accepted draft was purchased by the Surety Acceptance Corporation, which later sold it to a large insurance company at 1½% discount.

After accepting the draft and receiving the documents, the Sutcliffe National Bank sent these documents to W. O. Lyons and Company, receiving in return a duly executed trust receipt. On presentation of the bill of lading, W. O. Lyons and Company was able to take possession of the shipment of wool when it reached New York.

Upon the maturity date of the acceptance, W. O. Lyons and Company paid to the Sutcliffe National Bank the full amount of the draft, plus ⅜ of 1% commission.

For what reasons was the Sutcliffe National Bank justified in granting W. O. Lyons and Company a $50,000 letter of credit in

January, 1931? To what extent should the then current condition of the wool market have influenced the bank in its decision as to whether or not to do the financing? Should the Sutcliffe National Bank have investigated the standing of Julio Fernandez y Compania in evaluating the risk involved in issuing this letter of credit?

Is there any essential difference between the credit problem involved in this case and that which exists in the making of customer loans, either secured or unsecured? If not, how can one account for the fact that the Sutcliffe National Bank charged W. O. Lyons and Company 4½% on its unsecured note and handled acceptance financing for the same company at the rate of 1½%?

In the course of this transaction the Banco Territorial increased its balance in dollars with the Peddie Trust Company. Was this desirable in view of the extreme weakness of the Argentine peso in New York early in 1931.[1] If not, what measures might the Banco Territorial have taken to protect itself against fluctuations in the rate of exchange?

How did the Banco Territorial arrive at its buying rate of 143.57 for 90-day New York exchange in Buenos Aires?

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[1] On January 13, 1931, Argentine exchange reached the lowest levels recorded since 1921. See *The New York Times*, January 14, 1931, p. 37, col. 6ff.

STRAWBRIDGE NATIONAL BANK

PURCHASE OF BANKERS' ACCEPTANCES IN LONDON

The Strawbridge National Bank, although not one of the largest of the New York City banks, maintained a well-organized and efficient foreign department and had correspondents in important financial centers throughout the world. This department was directed by one of the vice presidents, Mr. Arthur.

The foreign department was given a certain portion of the bank's funds for the conduct of its operations. In addition, funds were temporarily transferred from other departments when such funds could be more profitably employed by the foreign department. Mr. Arthur had the right to refuse transfers to his department. These interdepartmental transfers were under the supervision of another vice president, Mr. Ralston, who acted as liaison officer between the various individuals responsible for the investment of the bank's resources. When a transfer was made, the receiving department was charged a nominal rate of interest, and the department which relinquished the funds was credited at the same rate. Earnings in excess of this rate were credited to the department receiving the funds, and, unless the officer in charge believed that such an excess were possible, he would not accept the transfer.

During 1929 there were no transfers to the foreign department because there was a great demand for funds in the United States, where interest rates remained high until the latter part of the year.[1] As these rates eased, however, after the collapse of security prices in October and November, the situation changed, and in the first week of January, 1930, Mr. Ralston asked Mr. Arthur if he could use $3,000,000 for 90 days at 3½%. Mr. Arthur replied that he would take $2,000,000, since he knew that this amount could be loaned directly to two of the largest German banks at rates which would give the department a profit. In regard to the third million, he was doubtful. The three countries where such short-time loans were generally made were Germany, France, and

[1] For money rates, see Appendix III.

England. He did not wish to loan more than $2,000,000 in Germany at that time, and a loan in France would not be profitable since short-time money rates were much lower there than in New York. Money rates in London were somewhat higher than those in New York, so that it might be profitable to purchase bankers' acceptances in England.[1] Whether or not this step should be taken depended on the exact price at which bills could be purchased and upon the rates of exchange between the United States and England. It was not considered profitable to buy foreign bills unless the interest received was at least ½ of 1% higher than the cost of the funds to the foreign department. Mr. Arthur, therefore, postponed his decision concerning the third million until the next morning, and instructed the bank's trader, who specialized in London exchange, to send the following overnight cable to the London correspondent of the Strawbridge National Bank:

Quote us £200,000 90-day prime endorsed bank bills.

Since the London market opened at 10 A.M. Greenwich time, the equivalent of 5 A.M. in New York, the return cable was at hand early the next morning, and when he arrived at his office, Mr. Arthur found the following memorandum from the bank's London trader:

London correspondent quotes us £200,000 90-day prime indorsed bank bills at 4 5/16. Spot cable transfers opened 4.87 9/16 and 90-day sterling futures selling at 4.86 11/16.[2]

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[1] In addition to the purchase of bankers' acceptances, a bank may make short-time loans in England in the following forms: by the purchase of Treasury bills; by the placing of loans which correspond to call loans in the United States; by the accumulation of trade bills; and by the making of fixed deposits in English banks. Rates on bankers' acceptances in London and British Treasury bills can be found in Appendix III.

[2] Future markets exist for various currencies. In many cases these are nominal, but in the case of England, France, and Germany, there are well-developed markets. Of these, that in sterling is the outstanding example. Such markets are dealers' markets and few quotations are published. Exchange for delivery at a future date sells at either a premium or a discount upon the rate for spot exchange. In covering present transactions to avoid the risks of exchange, the spread between spot exchange and cost of futures is a fundamental factor. If, for example, spot sterling is purchased at 4.86 and an equal amount of 90-day sterling is sold at 4.86½, there is a gain of a half cent per pound sterling for the 90 days, or two cents per year. This gain should be added to the interest received on the investment. On the other hand, if 90-day sterling were sold at 4.85½, there would be a corresponding "loss" to be subtracted from the interest before determining the actual return. Quotations for futures on London, Paris, and Berlin are published in the *Journal of Commerce* (New York). For method of computing, consult case of Whitehall National Bank, *infra*, Exhibit 2 (D), third footnote, and (H).

If Mr. Arthur decided to purchase the bills, $1,000,000 would have to be transferred from New York to London by the purchase of a cable transfer, and then, because it was the policy of the bank to cover such transactions, it would be necessary to sell sterling for delivery 90 days in the future.

What per cent per annum would the bank realize on the investment?

Should the transaction have been hedged?

Should these bills have been purchased?

Enumerate and evaluate the factors which determine the amount of the spread between present and future rates in foreign exchange.

WHITEHALL NATIONAL BANK

SCOPE AND OPERATION OF A FOREIGN DEPARTMENT

At a meeting of the board of directors held during the first week in October, 1930, the comptroller of the Whitehall National Bank, one of the smaller downtown banks in New York City, submitted departmental income and expense figures for the third quarter. Gross and net earnings were far below those for the same quarter in recent years, and the directors sought to remedy this situation by studying departmental costs and discovering new sources of revenue.

In the comptroller's July-September report the foreign department of the Whitehall National Bank was charged with a small deficit. The directors realized that circumstances made such a showing almost inevitable. The foreign department, as such, never had returned large profits,[1] and the volume of business which it handled during the first nine months of 1930 had been curtailed sharply by the decline in domestic business activity and in foreign trade of the United States.[2] Nevertheless, the board

[1] It is conceded generally that only the largest and best-organized foreign departments are money makers. Commissions received are small, since there is no universally accepted schedule of rates charged and keen competition exists among banks. In addition, foreign departments perform many services gratis for customers of other departments of the bank.

In spite of their lack of profitability, foreign departments are necessary to all downtown commercial banks in New York City and to many institutions in other cities. Large business concerns and country banks will not give their accounts to a city bank which is not equipped to handle foreign transactions. Furthermore, the maintenance of a foreign department is considered good advertising, since it brings in new customers who may later direct profitable business to other departments. In short, the desirability of having a foreign department must be determined in the light of the best interests of the bank as a whole. On this basis such a department may prove indispensable without being profitable in itself.

[2] *Commercial and Financial Chronicle*, Vol. 131 (October 18, 1930), p. 2431, presents the following data on the foreign trade of the United States, for the period January to September, inclusive:

	Exports	Imports
1929	$3,843,676,000	$3,360,017,000
1930	2,958,509,000	2,401,838,000
Decline in 1930	23.0%	28.5%

believed that it would be advisable to consider means of increasing the gross income as well as of cutting down the cost of operating the foreign department.

In order to facilitate the directors' investigation, Mr. D. E. Long, manager of the foreign department, was requested to submit at their next meeting such information as he believed would prove helpful to them. Mr. Long prepared the following memoranda, shown in Exhibits 1 to 3:

1. A general statement as to the operations of the foreign department during the first nine months of 1930.

2. Typical examples of the most important income-producing operations performed by the department and an explanation of the profits derived therefrom.

3. A list of the more important services which the department performed gratis, or for which it made only a nominal charge.

EXHIBIT 1

General Survey of Foreign Department Operations during the First Three Quarters of 1930

During 1930, as in the past, the four outstanding activities of the foreign department have been: acceptance financing, making foreign collections, foreign exchange operations, and the issuing of travelers' letters of credit and travelers' cheques. These activities are listed, regardless of profits, in the order of the dollar volume of business which the bank has transacted under each classification during 1930.

Thus far in 1930 the foreign department has maintained at an average figure the amount of acceptance financing done. The volume of trade throughout the world has declined sharply, thus reducing financing of this kind handled for importers and exporters in this country. However, two factors have operated to counteract this unfavorable influence. In the first place, the discount rate on bankers' acceptances generally has been lower in New York than in any other of the world's financial centers except Paris. Secondly, internal affairs in many important countries, notably Germany, Spain, Italy, and the South American republics, have been unsettled. The result has been that many transactions between foreign countries have been financed in terms of dollars,* and a large compensating volume of acceptance financing, which in former times would have been done in London, has been diverted to New York banks. The Whitehall National Bank has secured its full share of this business at our usual commission of 1% per annum for accepting drafts drawn on us. The expenses incurred by the foreign department in accepting a draft are negligible, so that this is a desirable class of business in spite of the small commissions which are realized therefrom.

Collection of foreign items for customers in this country has fallen off in volume this year, an inevitable result of the decline in exports from the United States. This fact, however, is not a particularly important one in accounting for the showing made by the foreign department. The practice in this country is to regard the collection of items abroad as largely in the nature of a service. Consequently, competition forces this bank to charge commissions which barely cover the clerical expense of handling this type of business. Our

* See example G in Exhibit 2.

EXHIBIT 1. (*Continued*)

customary commission on a foreign collection is ⅛ of 1% of the invoice value of the draft. It is frequently necessary, however, to perform this service without profit or at a substantial loss to the department* for customers who habitually have a large number of items for collection and who are inclined to haggle over commissions. Unfortunately, the precedent in this regard is so strong that if the bank refused to make concessions to such customers, it would lose accounts which are otherwise profitable.

The sale of demand and cable exchange and the execution of orders for "forward" delivery have declined in volume this year. Remittances by our commercial customers have been considerably reduced, owing to the lower volume of imports, while unemployment and adverse business conditions in this country have resulted unavoidably in a decrease in the amount of funds sent abroad by immigrants. It has been our experience also that remittances of interest and dividends on American securities held abroad have declined markedly. This fact has been due apparently to withdrawals of foreign funds from the markets in this country. The amount of profit realized by the foreign department in sending money abroad is highly variable, depending, to a great extent, on the bargaining power of the customer.† However, in general, this is a profitable type of transaction, and the decrease in remittances by individuals has had a particularly adverse effect on the income of the foreign department.

The dislocation of a large number of foreign currencies and the attendant sharp and unpredictable fluctuations in exchange rates have eliminated almost completely what, in ordinary times, constitutes a most important source of revenue to the majority of foreign departments. The reference here is to the profits which may be realized from a correct interpretation of the future course of exchanges on foreign countries. While this department does not countenance excessive speculation in exchange, it is our belief that omission of "hedging" on many transactions is justified when supported by a careful study of the factors which will influence the future movement of the rate between the United States and any given foreign country. Because of the unsettlement referred to above, however, the foreign department has felt it to be the part of conservatism to cover almost every transaction which has been entered into this year.‡ It should be noted that, in the past, this department generally has met with success in forecasting future rates, and that no small part of its profits have been derived therefrom.

Of the activities of the department, other than those classed as operations in foreign exchange, none is more profitable than the sale of travelers' letters of credit and travelers' cheques. During recent years this phase of our business attained a large volume, but, unfortunately, it has declined more than any other in 1930. This situation is due entirely to the depression in the United States, and there is every reason to believe that foreign travel will increase again in future years. It may be noted that the clientele of certain banks is such that business conditions have little influence on the extent of their customers' travels. That, however, has not been the experience of the Whitehall National Bank.

During the current year the foreign department has suffered a decline in business and profits along other lines than those mentioned above. To cite only a few examples, low money rates in the United States have caused a reduction in the number of transactions upon which the department can charge commissions for lending funds in this country on behalf of our correspondents abroad. The same factor has eliminated the possibility of deriving a profit by borrowing money in other financial centers through the drawing of finance bills and lending the funds at a higher rate in New York. Curtailed business activity has decreased the volume of acceptances arising from the domestic shipment and storage of goods.

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* See example D in Exhibit 2.
† See second footnote to example B in Exhibit 2.
‡ See example H in Exhibit 2.

EXHIBIT 1. (*Continued*)

In summary, the small deficit shown by the foreign department does not seem to be out of line with its average profits in other years when considered in the light of the difficulties which it has been facing. The department, in recent months, has dismissed several employees and has made every effort to reduce operating expenses. Consequently, it appears that little can be done to remedy the present situation, and that, if events are allowed to take their natural course, the department will soon be reestablished on an earning basis.

EXHIBIT 2

Description of Different Types of Income-producing Operations

(A) Issuing Travelers' Letters of Credit and Travelers' Cheques.

On October 14, 1930, Joseph Lombardi applied to the foreign department for a $5,000 letter of credit. Mr. Lombardi, who was a good customer of the bank, instructed the foreign department to debit his account with this amount, plus the bank's commission. In this instance the charge for issuing the letter of credit was ¼ of 1%, or $12.50.

On the same day, A. N. Blair purchased from the foreign department $1,500 worth of travelers' cheques in denominations of $10 to $100. Mr. Blair paid $1,507.50 in cash for these cheques, giving the bank ½ of 1% commission.

In each instance the Whitehall National Bank had the use, without interest, of the funds provided by these customers until the drafts under the letter of credit and the travelers' cheques were presented for payment.

(B) Selling Drafts in Foreign Currencies.

On October 18, 1930, H. Schmidt presented his check for $1,000 to the clerk in charge of the sale of foreign drafts, requesting that the bank issue a demand draft in favor of Augusta Schmidt for the equivalent number of German marks. On that date German demand exchange was quoted at $.2378 per mark, and the Whitehall National Bank was charging $.2381 on small transactions.* Accordingly, a draft for 4,199 marks, 92 pfennigs, payable to Augusta Schmidt, was issued on the bank's Berlin correspondent. In this transaction the differential between the market rate and the rate charged by the Whitehall National Bank produced a gross profit of $1.26.

(C) Selling Cables.†

On October 16, 1930, T. A. Malone requested the Whitehall National Bank to sell him a sterling cable for 1,000 pounds, payable to G. and R. Stephenson, Ltd., of London. On that particular day the prevailing rate for cables was $4.86 per pound, having risen rather sharply during the preceding week. The foreign department's selling rate for cable transfers was $4.86½, giving it a gross profit of $5.

The department was glad to execute this order regardless of the cited profit realized, because it provided an opportunity to reduce the London balance with an additional speculative profit. This balance had been built up largely through remittances of demand and time drafts purchased during September and early October at much lower prices.

(D) Purchasing Exchange.‡

On October 20, 1930, the Terry Oil Company, a large producer and refiner of petroleum and an old customer of the Whitehall National Bank, offered for

* The addition to the generally quoted rate which a bank makes on a transaction of this kind depends on the amount involved, the probable future course of the particular exchange in which the draft is drawn, and the bargaining power of the customer. Usually rates for small drafts in various currencies are set each day. However, there is no accepted standard of commissions in foreign exchange dealings, just as there is no one official quotation on exchange rates. Hundreds of banks and dealers, both here and abroad, are continually offering and bidding on various types of exchange, and both rates and commissions are highly variable. Even the published exchange rates are merely approximations of the figures quoted by the largest and best-known international bankers.

† Escher, Franklin, *Elements of Foreign Exchange*, ninth edition.

‡ *Ibid.*, pp. 74–82.

EXHIBIT 2. (*Continued*)

sale a clean* 90-day sight draft for 1,950,000 francs. This draft was drawn on D'Orsay Frères, an importer in Paris, and covered the invoice price of a shipment of oil from the United States to France. Although the draft was not drawn under a letter of credit, the credit standing of both the Terry Oil Company and D'Orsay Frères was so good, and the bank's relationship with the former was so close, that the foreign department agreed to purchase the draft at a very slight increase over the then current rate of exchange for such bills.

The Whitehall National Bank bought the draft in question at \$.0390 7/16, paying a total of \$76,135.31. After purchasing the draft, the Whitehall National Bank mailed it to its Paris correspondent with instructions to procure acceptance and arrange for discount. Accordingly, the draft was discounted at the Paris rate of 2%, 1,939,925 francs† being credited to the account of the Whitehall National Bank.

When this transaction took place, the department did not wish to have a larger balance in Paris, as would be the case if these funds were left on deposit with the Whitehall National Bank's Paris correspondent. It was believed that the next important movement of the franc demand exchange rate in New York would be downward from the exceptionally high figure of \$.0392 7/16 then prevailing.‡ Consequently, it was decided to hedge the transaction by selling the Whitehall National Bank's own demand draft for 1,939,925 francs on Paris at the same time that the 90-day draft was purchased from the Terry Oil Company.§ At the market rate of \$.0392 7/16, this draft brought \$76,129.93, and left the bank's Paris balance unchanged. However, a loss of \$5.38, exclusive of clerical expense, was suffered on the transaction.

(E) Collecting Foreign Items.

On the same day Frederick Blake, Incorporated, a small exporting concern, presented a documented demand draft for 300,000 francs, drawn on a firm in Marseille, France. Since Frederick Blake, Incorporated, transacted little business with the Whitehall National Bank, and the importer involved in the transaction was not known to the foreign department, the department took this draft for collection only. That is, Frederick Blake, Incorporated, would not receive the proceeds of the draft until after the Marseille correspondent of the Whitehall National Bank had collected from the importer and credited the bank's account.

The charge made by the foreign department on this transaction was calculated as follows:

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* Banks purchase clean drafts, that is, those not accompanied by documents, only from exporters of the highest credit rating. In this case the Terry Oil Company had sent the documents direct to D'Orsay Frères.

† Discount in France is computed on the basis of a 360-day year, in England on a 365-day year, and in Germany by the month, regardless of the number of days therein. In most other European countries the 365-day year is used. In all foreign countries the customary 3 days of grace are added to the period for which a 90-day draft is discounted.

‡ In October, 1930, conditions appeared to point toward a decrease in the supply of, and an increase in the demand for, foreign exchange in France. If such a situation developed, it would result in an increase in the number of francs required to buy foreign currencies in France, and in a corresponding softening of franc exchange in other countries. The underlying considerations which made this movement of franc exchange appear probable were as follows (see *The New York Times*, October 13, 1930, p. 35, col. 5, and p. 36, col. 2):

1. A poor wheat crop in France during 1930 would make it necessary in 1931 to import grain worth approximately two and one-half billion francs, whereas almost none had been purchased abroad in 1930.

2. The world trade reaction promised to curtail tourist travel in France during 1931, and hence the amount of foreign exchange brought into the country.

3. French exports fell off sharply during the first eight months of 1930, manufactured articles exported showing a decline of almost 25% compared with the same period in 1929. This condition was expected to continue because the price level of French goods was much higher than that of foreign goods and was not declining as rapidly.

§ The bank's demand draft, which was sold in the New York market, would have to be sent to Paris in order to cash it. Consequently, the Paris bank would be called upon to pay this draft out of the balance of the Whitehall National Bank on the same day that it had credited that account with the proceeds realized from discounting the draft of the Terry Oil Company. In spite of the fact that these two transactions normally would cancel on the same day, conservative practice requires that the Whitehall National Bank have a deposit balance of at least 1,939,925 francs in Paris on the day that it sells its own demand draft for that amount in New York.

EXHIBIT 2. (*Continued*)

Value of Invoice at $.0392 7/16 per Franc............		$11,773.12
Correspondent's Commission at 1 1/10 Mills per Dollar	$12.95	
French Stamp Tax at 1/40 of 1%..................	2.94	
Commission of Whitehall National Bank at 1/8 of 1%..	14.72	
Cost of Collection...........................		30.61
Total to Be Received by Frederick Blake, Incorporated, or at the Rate of Slightly Less than $.0391 7/16 per Franc of the Invoice Price*...............		$11,742.51

(F) Accepting for Correspondents to Finance Exports.†

On October 23, 1930, the K. R. Barton Company, cotton dealers, presented a 90-day documented sight draft for $20,000 to the Whitehall National Bank for acceptance. This draft covered a shipment of raw cotton to a well-known German importer. A few weeks previous to this time, the importing house in question had arranged with the Suddeutsche Bank of Berlin for an extension of credit. Since money rates were much higher in Germany than in the United States, the importer wished to have drafts drawn on him in dollars and discounted in New York.‡ Accordingly, the Suddeutsche Bank requested the Whitehall National Bank, which was its New York correspondent, to open a credit in favor of the K. R. Barton Company. Under the terms of this credit, the K. R. Barton Company could draw drafts on the Whitehall National Bank, have them accepted, and discount them in the open market. After receiving the cash, the K. R. Barton Company would ship the cotton and deliver the documents covering it to the Whitehall National Bank, which, in turn, would forward them to the Suddeutsche Bank.

The Suddeutsche Bank agreed to furnish the Whitehall National Bank with funds to meet the acceptances before they fell due, and to pay it, in addition, 1% per annum for the service of accepting. At this rate the Whitehall National Bank's commission on $20,000 for 93 days amounted to $51.67.

(G) Accepting to Finance Transactions Between Foreign Buyers and Sellers.§

On October 27, 1930, the Whitehall National Bank received the following copy of a letter of credit from its Madrid correspondent:

Credit #119,966 — Madrid, Spain
$50,000 — October 15, 1930

Whitehall National Bank
New York City, U. S. A.

Gentlemen:

At the request and for the account of Garcia Hermanos, Madrid, we hereby authorize Julio Fernandez y Compania, Buenos Aires, to value on you at Three (3) months sight for any sum or sums not exceeding in all Fifty Thousand Dollars ($50,000) for the invoice cost of wool in the grease to be shipped to Madrid.

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* Schedules of commissions and stamp taxes are published by prominent banks. In this case Frederick Blake, Incorporated, doubtless consulted such a schedule, performed the above computation in advance, and quoted goods which it would have priced at $11,742.51 at 300,000 francs. Some addition to the price in francs may also have been made by the exporter as protection against a decline in French exchange between the time the draft was drawn and payment was received in dollars.

† Westerfield, R. B., *Banking Principles and Practice*, revised printing, pp. 819–822.

‡ On October 23 the market discount rate in Berlin was 4⅞%, while in New York the rate on bankers' acceptances was 2% bid. Had drafts been drawn in marks and sent to Germany to be discounted, the Whitehall National Bank would have charged the K. R. Barton Company 4⅞% for 90 days. The K. R. Barton Company, in turn, would have quoted a price on its cotton high enough to compensate for this discount charge. With the drafts drawn in dollars, however, they could be discounted for 2%, and, consequently, the K. R. Barton Company would quote a lower price to the importer.

§ On the subject of "dollar exchange," read Regulation C, *Annual Report of the Federal Reserve Board*, 1930, pp. 238–239; Rulings of the Board of Governors of the Federal Reserve System, 13.2300–13.2304, *Digest of Rulings of the Board of Governors of the Federal Reserve System from 1914 to October 1, 1937*, pp. 150–151.

EXHIBIT 2. (*Continued*)

The bill must be drawn in Buenos Aires prior to the first day of December, 1930, and advice thereof given to you in original and duplicate, such advice to be accompanied by bill of lading to order of the Whitehall National Bank, invoices, and insurance certificate covering the goods shipped.

We hereby agree with the drawer, endorser, and *bona fide* holders of bills drawn under and in compliance with this credit, that the same shall be duly honored on presentation at your office in New York.

Banco Madrileño

In return for a commission of 1% per annum for accepting, which in this case would amount to 95 days' interest* on the basis of the 360-day year, or $131.94, the foreign department held itself in readiness to accept drafts drawn under this credit when they should be presented. On presentation, such drafts and the documents attached thereto would be examined by the Whitehall National Bank. If they were in order, the draft would be accepted and returned to the bank presenting it,† while copies of the documents would be forwarded to the Banco Madrileño. Before the acceptances so created fell due, the Banco Madrileño would furnish the funds with which to meet them and, in addition, the commission due the Whitehall National Bank.

(H) Lending Money Abroad.‡

On October 9, 1930, the German Reichsbank increased its discount rate from 4% to 5%, in an effort to check the withdrawals of foreign capital which had been taking place since the successes of the Communist party in the September elections. At that time it was difficult to secure a profitable rate of interest on sound, short-term loans in the New York market. Consequently, on October 15, when the lending officers of the Whitehall National Bank learned that the Suddeutsche Bank, its Berlin correspondent, was desirous of borrowing money abroad, they decided to lend this bank the equivalent of $1,000,000. The rate which the Suddeutsche Bank was willing to pay on such "monthly dollar loans" was 4⅞%.§

When the manager of the foreign department was advised of this intention, he at once bought a spot cable at the current cable rate of $.2378 per mark, transferring 4,205,215 marks to the Suddeutsche Bank.

The foreign department manager feared the results of the overflow of gold from Germany, which had not ceased with the increase in the discount rate, and the future trend of internal affairs in that country, which was by no means easy to foresee. Consequently, he decided to hedge the transaction and sold a 4,222,298 mark cable,‖ deliverable in 31 days, in the futures market. The agreed price he would receive for this cable at the end of 31 days was $.237625 per mark,¶ or a total of $1,003,323.56. Therefore, when the Suddeutsche Bank cabled its remittance on November 15, this cable would be delivered against the future contract, and the bank would have $3,323.56 to show for its 31-day investment of $1,000,000. This return, figured on the American 360-day year basis, would amount to approximately 3.86%.

(I) Arbitraging.

At 10 A. M. on October 29, 1930, the trader in the foreign department of the Whitehall National Bank received a cable from the bank's English correspondent stating that the buying rate on telegraphic transfers of French francs was 123.83 francs per pound sterling. At the same time, sterling cables were

* Assuming a draft for the entire $50,000 were presented during November, it would have 92 days to run until the corresponding date in February. To this length of time would be added the customary three days of grace.

† These drafts could be discounted in the New York market by the same procedure as that outlined in case of W. O. Lyons and Company, *supra*.

‡ See case of Strawbridge National Bank, *supra*.

§ The practice among German banks is to borrow abroad by the month, regardless of the number of days in that month. The advantage to the Suddeutsche Bank of obtaining money at ⅛ of 1% below the Reichsbank's discount rate is obvious.

‖ The amount of this cable includes the interest receivable from the Suddeutsche Bank, figured as one-twelfth of the annual rate.

¶ Mark futures were selling at a 1¾-point discount at the time.

EXHIBIT 2. (*Continued*)

quoted in New York at \$4.85 $^{13}/_{16}$ and franc cables at \$.0392$^{3}/_{8}$. The trader at once sold a cable for 12,383,000 francs on the bank's correspondent in Paris, and cabled its correspondent in London 100,000 pounds with instructions to buy francs and cable them to Paris for credit to the account of the Whitehall National Bank.

The 12,383,000 francs, which the trader sold in New York, brought in \$485,877.96, while the 100,000 pounds which he cabled to London cost \$485,812.50. Consequently, the bank showed a gross profit of \$65.46 on the transaction. Its balance in Paris at the close of the day remained unchanged, having been drawn down by 12,383,000 francs by the sale of the cable in New York but cover amounting to the same number of francs having been supplied through London.

EXHIBIT 3

Important Services Performed by the Foreign Department, Gratis or for a Nominal Charge

(A) Foreign Credit Information.

The foreign department maintains a credit division, which has on file information on more than 15,000 foreign banks, firms, and individuals. Up-to-date reports are being received constantly from our correspondents abroad.

Credit reports are furnished to customers free of charge, provided that they do not request an unreasonable amount of such service. Noncustomers are charged 25 cents each for reports on names contained in our files, and \$3.50 each for reports on other names.

This division is not expected to make, and never has made, a direct contribution to the profits of the foreign department.

(B) Information on Economic Conditions Abroad.

The foreign department prepares a monthly bulletin on conditions in the principal foreign countries, which it distributes without charge. It is also prepared to supplement its published information on this subject for the benefit of customers.

(C) Travel Bureau.

In addition to the sale of letters of credit and travelers' cheques, the foreign department is equipped to secure steamship, railroad and hotel reservations, assist in obtaining passports and visas, and furnish letters of introduction to foreign bankers and business men.

(D) Other Services.

For the convenience of customers, the bank undertakes to collect and analyze information regarding leading markets and important commodities, to explain the practices of modern foreign trade, and to suggest suitable agents and contacts abroad to reliable exporters and importers. Translations from and into the principal commercial languages are made for customers without charge.

(E) Special Services to Valued Customers.

The charges which the bank makes to large customers for the collection of foreign items and the sale of drafts and cables are so small that they may be classified as pure accommodations.

For which types of income-producing operations or services, and in what manner, should the directors expect or instruct the foreign department manager to increase income, provided that due consideration is given to the business and financial conditions prevailing in October, 1930?

Should not the foreign department manager have made greater, rather than less, net profits from speculation in exchange during a period of "dislocation"? Is this particular manager unduly conservative as shown by his own memorandum-record of hedging operations?

The drawing of finance bills, in the past, has been an important and a profitable part of foreign exchange dealings by American banks. Why were no such bills drawn by the Whitehall National Bank during the fall of 1930? Outline the profit-making possibilities of the drawing of finance bills in more normal times, and trace the essential steps involved.

Formulate a principle or rule, to be followed in bank administration, for determining the losses, or amount of loss, that may be incurred properly through, or by, any department offering in whole, or in part, some form of free service to the bank's customers in other departments.

Should one advocate the establishment of a foreign department in a bank having deposits of $40,000,000 in Boston? In Chicago? In Kansas City, Missouri?

Should customers be charged for the services enumerated in Exhibit 3?

Suggest reasons why commissions or profit margins on foreign exchange services are small and highly variable, whereas brokerage commissions on stock exchange transactions are fixed.

Is it probable that business secured in the manner exemplified by the handling of the Terry Oil Company (see Exhibit 2) compensates for the effect which such price cutting must have on the future trend of profits in foreign exchange operations?

VI

GENERAL ADMINISTRATIVE PROBLEMS

24. SPECIALIZATION AND RESPONSIBILITIES OF OFFICERS AND DIRECTORS

FIFTH UNITED NATIONAL BANK

STAFF ORGANIZATION FOR THE ADMINISTRATION OF CREDITS[1]

The Fifth National Bank and the United National Bank were merged in October, 1928, under the name of the Fifth United National Bank. The two institutions were located in one of the larger Ohio cities, and their statements as of the time of the merger show loans and discounts, respectively, of $83,666,000 and $107,451,000. One of the problems presented by the merger was to decide upon the form of organization for the handling of customers' loans. This problem involved, first, the division of authority to grant loans among the executive officers, the credit department, and the loan officers. Secondly, it was necessary to decide whether or not the loan officers should specialize, and if so, whether by industries or according to geographical areas.

The policies of the two banks in regard to these questions had been widely divergent. The organization of the Fifth National Bank for the administration of credits is shown in Exhibit 1. The power to grant or refuse loans was divided among three groups of individuals, as follows: the three senior executive officers; the eight so-called loan officers, four vice presidents, and four assistant vice presidents; and the vice president and assistant vice president in charge of the credit department. The approval of the two loan officers under whose jurisdiction the particular loan might fall was sufficient on loans of less than $50,000. Both such officers, however, had to approve every loan. On loans of over $50,000, but under $100,000, the approval of either the vice president or the assistant vice president of the credit department was necessary in addition to that of two loan officers. The credit department officers were thus given veto power over certain of the decisions of the loan officers.

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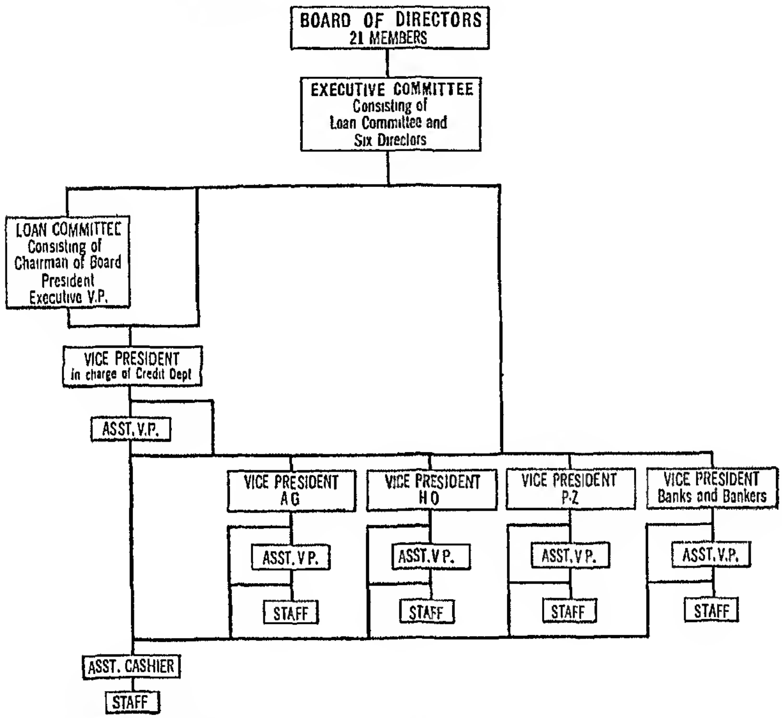
[1] See: Roethlisberger, F. J., "Social Behavior in Industry," *Harvard Business Review*, Summer, 1938, pp. 424–435; Hopf, H. A., "Problems of Bank Organization," *Bulletin of the Taylor Society*, Vol. XII, 1927, pp. 352–374; American Bankers Association, *Commercial Bank Management Booklet No. 6, Duties and Qualifications of Executive Bank Officers.*

Loans in excess of $100,000 had to be passed upon not only by the loan officers and the credit department officers, but also by at least two of the three senior executive officers. The latter three met daily for this purpose and constituted a loan committee, as indicated on the chart. It must be emphasized that all these

EXHIBIT 1

Organization Chart of the Fifth National Bank*



* Includes only the organization for administration of credits.

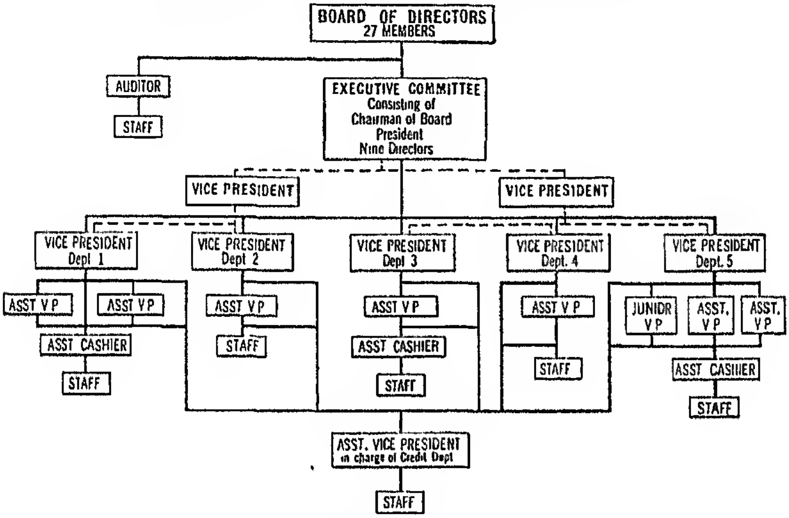
provisions applied only to new loans, to the establishment of credit lines, and to the increase of credit lines already established. When the amount of a credit line once had been determined for a given period, usually one year, loans within this amount and time, regardless of size, could be approved by either of the two originating loan officers. All established credit lines of $50,000 or over were reconsidered periodically for the approval of the senior executive officers and/or the credit department, depending upon the amount of credit involved. In special cases, also,

renewals were discussed with the senior executive officers, even though such loans were within the established credit lines.

The directors of the Fifth National Bank delegated to an executive committee their power to make loans. This committee consisted of the three senior executive officers of the bank and six directors. The board of directors had 21 members. The director members on the executive committee were rotated, the terms of three directors expiring every six months. Weekly

EXHIBIT 2

Organization Chart of the United National Bank*



* Includes only the organization for administration of credits.

meetings of the executive committee were held, in which all loans and renewals of $25,000 and over were reviewed, regardless of whether they were made under established lines. At the regular monthly meetings of the board of directors the reports of the executive committee were read, and its action approved or criticized.

As Exhibit 1 shows, all customers, except banks and bankers, were divided alphabetically among three pairs of loan officers, and a fourth pair was in charge of the loans to banks and bankers. There was no formal division of customers between the vice presidents and the assistant vice presidents, but the assistants usually handled the smaller and/or less doubtful credits. The credit department furnished information and analyses which

the loan officers used in making decisions on loans. This part of the credit department's work was in the charge of an assistant cashier.

The loan administration organization of the United National Bank is given in Exhibit 2. Customers were divided into five groups, as shown in Exhibit 3, and each group was assigned to a separate department in charge of a vice president. The number of other officers in each department depended upon the size and importance of the business allotted to that department. Departments One and Five were the larger and more important. The authority to establish credit lines and to grant loans rested entirely with department heads, upon the theory that a large bank was in reality nothing more than a group of small banks and that

EXHIBIT 3

Division of Customers of United National Bank among Departments

Department One

Iron, steel, and metal parts.
Machinery.
Electrical equipment.
Automobiles.
Automotive equipment.
Miscellaneous manufacturing.

Department Two

Textile manufacturing.
Clothing manufacturing.
Wholesale dry goods, groceries, and drugs.
Department stores.
Mail order houses.
Tire and rubber manufacturing.
Miscellaneous retailing.

Department Three

Petroleum and petroleum products.
Coal.
Power, light, and transportation.
Building materials and supplies, including glass, paint, plumbing and heating supplies, and lumber.
Hardware.
Furniture and wood products.
Paper, publishing, and printing.

Department Four

Food manufacturing.
Meat products.
Candy, beverages, and tobacco.
Produce, commission, and cold storage.
Grain and flour.
Restaurants and hotels.
Hides, leather, and shoes.

Department Five

Banks and bankers.
Collateral stocks and bonds.
Real estate.
Installment financing.

each department should be operated as if it were an independent institution. Subordinate officers within the departments had no power to authorize loans, but merely recommended action to the vice presidents in charge. The function of the credit department was limited to furnishing information for the use of the officers in the loan departments.

Although the department heads were given complete autonomy on large loans and on situations which were especially complicated, they were expected to secure the advice of one of two senior vice presidents. One senior vice president acted in an advisory capacity to the departments numbered One and Two, and the other to the remaining three. The senior vice presidents were not in control of the department heads. There were no limits on the amounts which department heads could loan, and the written approval of a senior vice president was not necessary when he was consulted in regard to a loan.

One of these senior vice presidents was made responsible for the purchase of outside commercial paper. On special situations the senior vice presidents sometimes conferred with members of the executive committee.

In addition to acting as consultants to the department heads, the two senior vice presidents reviewed annually all credit lines handled in the departments with which each was affiliated. This review consisted of studying the credit summary contained in each customer's credit folder and examining as much of the additional information as was essential to a thorough understanding of the case. Each of the summaries was written by an assistant vice president and, before being submitted to the senior vice president, was approved by the department head or vice president. In the case of these reviews, formal approval of the advisory officer was required, and differences of opinion were reconciled in conference with the department heads.

A further contact of the two senior vice presidents and the loan officers was secured at daily meetings with the department heads and their assistants, at which meetings a list of all loans made and renewed during the previous day was read. Each officer, when it seemed advisable to him, questioned, criticized, or supplied additional information in regard to the loans made by the other officers.

The highest officers of the United National Bank acted formally on loans only through their membership in the executive com-

mittee. This committee was made up of eleven directors: the chairman of the board, the president, and nine other directors. According to the by-laws, eight of the eleven directors, including the two executives, were appointed annually by the board of directors and served for one year. The other three directors were appointed twice a year and served but six months. This method of appointment secured a rotating membership. The executive committee met once a week, and at these meetings all loans and credit lines of $50,000 and over were reviewed. The reviewing process was so arranged that each credit line automatically came up for review twice a year.

The outside directors of the bank, besides being represented on the executive committee, were informed of the bank's condition through the annual report of the auditor and the quarterly reports of the president. As the chart shows, the auditor was responsible to the directors, and in his report to them he classified the loans in three groups, as follows: (1) safe, desirable loans; (2) good loans, but loans which should be watched carefully; (3) dubious loans which probably should be charged off. The items listed by him in the third class were usually charged off. The loans listed in the second group were watched by the loan department officers, by the advisory vice presidents, and by the members of the executive committee; and every three months the president issued a report to the directors on the current status of these loans. Directors also received copies of the national bank examiner's reports. Regular meetings of the board of directors were held once a month.

As Exhibit 3 shows, the customers of the United National Bank were divided among the five departments according to the type of business which they conducted. This enabled the department officers to specialize in certain industries and trades. Since the industries grouped under department number One were unusually important in the Ohio city where the United National Bank was located, this department was the most important. The problems of department number Five were the most varied, and within this department the several officers specialized on the different types of business allotted to it. The vice president in charge of the entire department and one of the assistant vice presidents handled the loans to banks and bankers and collateral loans on stocks and bonds, the junior vice president specialized on real estate loans,

and the remaining assistant vice president dealt with installment financing.

In considering the problem of consolidation, the officers of the two banks discussed the method of dividing the loans among loan officers according to the geographical areas in which the customers were located. For example, one large New York bank, which operated under this method, had a vice president in charge of loans to customers in the Pacific Northwest. This division enabled the officer to travel in that territory and to become acquainted with local conditions. It also resulted in a certain amount of specialization by industries, since industries in many instances tend to geographical concentration. The officers concluded that this plan had certain merits, but that it was peculiarly applicable only to the large New York and Chicago banks. Such banks had a sufficient number of customers in each area to make geographical specialization profitable. The greater part of the business of the merged banks was confined to the middle western area surrounding the city in which the bank was located.

Characterize these two organizations according to the principles upon which they were constructed and the points of difference.

Which of the two types of staff organization would be better for the merged bank?

In the long run, which type should develop a higher quality of loan officer?

RANKIN v. COOPER

149 Fed. Rep. 1010 (U. S. C. C. 1907)

DUTIES AND RESPONSIBILITIES OF DIRECTORS OF NATIONAL BANKS—CIVIL LIABILITY PERTAINING TO LOAN ADMINISTRATION[1]

FINKELNBURG, District Judge.[2] This suit . . . brought by . . . George C. Rankin, the present receiver of the First National Bank of Little Rock [Arkansas], against 16 directors of said bank, to recover losses alleged to have been sustained by said bank by reason of alleged negligence and violations of the laws of the United States governing the management of national banks . . .

At the threshold of this case it must be said that the testimony does not show that any of the defendants in this proceeding gained or intended to obtain any pecuniary advantage or to make any improper personal gain out of the various transactions involved. So far as the evidence shows, the defendants were men in good standing in the community, and many of them active business men of high standing. Nor does it appear that they were guilty of knowingly assenting to or participating in the malversations of funds by the president of the bank which wrecked this one-time flourishing financial institution. The question rather is whether they were guilty of neglect in not knowing or ascertaining these things and in not taking steps to prevent or remedy them—such culpable neglect as would make them liable under the general principles of the common law governing the duties of bank directors which apply to national banks as well as all other banks, and also under section 5145, Rev. St. [U. S. Comp. St. 1901, p. 3463]—the national bank law—which provides that the affairs of such banks shall be managed by not less than five directors, and section 5147, which makes it incumbent on every such director to diligently administer the affairs of such banks.

Briefly summarized, I understand the law on this subject to be as follows: (1) Directors are charged with the duty of reasonable supervision over the affairs of the bank. It is their duty to use

[1] See also Ebersole, J. F., *Bank Management—A Case Book*, first edition, Warner v. Penoyer.

[2] Portions of this case are omitted.

ordinary diligence in ascertaining the condition of its business, and to exercise reasonable control and supervision over its affairs. (2) They are not insurers or guarantors of the fidelity and proper conduct of the executive officers of the bank, and they are not responsible for losses resulting from their wrongful acts or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors. (3) Ordinary care, in this matter as in other departments of the law, means that degree of care which ordinarily prudent and diligent men would exercise under similar circumstances. (4) The degree of care required further depends upon the subject to which it is to be applied, and each case must be determined in view of all the circumstances. (5) If nothing has come to the knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, upon the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible. Directors cannot, in justice to those who deal with the bank, shut their eyes to what is going on around them. (6) Directors are not expected to watch the routine of every day's business, but they ought to have a general knowledge of the manner in which the bank's business is conducted, and upon what securities its larger lines of credit are given, and generally to know of and give direction to the important and general affairs of the bank. (7) It is incumbent upon bank directors in the exercise of ordinary prudence, and as a part of their duty of general supervision, to cause an examination of the condition and resources of the bank to be made with reasonable frequency. I have drawn the foregoing propositions largely from the leading cases . . .

In applying the foregoing rules to the present case, I will first speak of the directors collectively, leaving any discriminations to be made between them for subsequent consideration. Briefly stated, it appears from the evidence that up to June 19, 1890, when H. G. Allis was elected president of the First National Bank of Little Rock, it had been a successful and prosperous institution; that soon after Allis assumed charge of its affairs he began to divert the proceeds of the bank partly in the form of improvident, excessive, and improper loans to himself, and partly in the shape of improvident, excessive, and improper loans to other persons

and corporations with whom he was affiliated, and engaged in speculative enterprises, notably the City Electric Street Railway Company of Little Rock, the McCarthy-Joyce Company, a mercantile company of Little Rock, the Press Printing Company, a corporation of Little Rock, and a number of other corporations and individuals which will be hereafter more particularly referred to. This diversion and misappropriation of the funds of the bank continued from June 19, 1890, until February 1, 1893, when the bank closed in an utterly insolvent condition, and a receiver was appointed to wind up its affairs. It appears that after realizing what could be realized on the assets of the bank, and after an assessment on the stockholders, there still remained a balance of $300,000 due and unpaid.

It further appears from the evidence that during the excellent administration of the affairs of this bank by Col. Logan H. Roots, the predecessor of Allis, the directors gradually fell into the habit of permitting the executive officers to manage the business of the bank with very little, if any, supervision on their part. There were no periodic examinations made by examining committees such as were customary in other banks at Little Rock and banks generally. The directors simply trusted Col. Roots and the executive officers acting under him. It appears that this policy of trusting and relying upon the president, cashier, and their assistants was tacitly transferred to Mr. Allis and his staff when he came into office in June, 1890, and the business of the bank was carried on in the traditional way, without any disturbing cause calculated to arouse suspicion or inquiry on the part of the directors until about the month of July, 1891, when rumors began to circulate in and about Little Rock unfavorable to Allis' management of the bank's affairs, and at the request of Dr. G. M. Taylor, one of the directors, a committee was appointed to examine the affairs of the bank, which committee made an elaborate report on the 25th day of November, 1891. In this report the attention of the board is directed to the large indebtedness of Mr. Allis and of his "immediate associates and enterprises," and that "they merit more careful consideration." It is also stated in this report that the committee does not think that the securities in the case of the City Electric and Belt Railways would sell for enough at that time to liquidate the indebtedness, and it is suggested that an early liquidation or payment in full of these accounts, together with a large reduction of Mr. Allis' personal

indebtedness, is deemed desirable. It seems that about the same time a government examiner made an examination which led to a letter from the Comptroller of the Currency, dated November 28, 1891, addressed to the cashier, and to which personal attention was also called by an individual notice from the Comptroller mailed to each director. In this letter, which is lengthy, the Comptroller calls attention to the loans to Mr. Allis, the City Electric Railway Company, the Belt Line, Bradford & Brown, and alludes to Allis' connection with those parties and companies, and reminds the directors that the "use of the funds of a bank by any officer to forward his interests in any speculative enterprises is most reprehensible and dangerous, and the directors of your bank, who are by law made responsible for the management of its affairs, should spare no efforts and lose no time in eliminating all paper of this character from the assets of your bank." The Comptroller in this letter also admonishes the directors that it is the duty of the board to meet more frequently, and that "the conduct of the affairs of a national bank is by law devolved upon the board of directors, and regular and frequent meetings are therefore very desirable." This letter presumably reached the bank on or about December 1, 1891, and was answered by the board in a lengthy reply December 8, 1891, signed by all the directors individually, except three (Logan H. Roots, William Farrell, and C. M. Taylor), reported as absent from the meeting at which the reply was agreed upon. In this letter the directors undertake to answer the Comptroller's criticism in many particulars, and show an apparent familiarity with the bank's affairs. They also express continued confidence in Mr. Allis' management and in the success of the bank. Notwithstanding all these warnings and admonitions, the directors seem to have proceeded in the same passive way as they did before, relying on Mr. Allis to straighten things out. Instead of that, however, Mr. Allis involved the institution more and more, finally leading to absolute ruin to himself as well as the bank. Even though the bad debts existing at the period referred to could not be recovered or reduced, no adequate effort, indeed no effort whatever, seems to have been made by the defendants to arrest their increase after they had been warned by the Comptroller and a committee of their own body. They failed to arouse themselves from their lethargy.

As has been well said, the courts in dealing with instances of negligence by the directors of banks "are under perplexing

restraint lest they should, by severity in their rulings, make directorships repulsive to the class of men whose services are most needed, or, by laxity in dealing with glaring negligences, render worthless the supervision of directors over national banks, and leave these institutions a prey to dishonest executive officers." With grave misgiving as to the liability of the members of the board for the wrongdoings of the president and his associates prior to December 1, 1891, I have finally determined upon that date as indicating a period of time when the members of the board certainly had been sufficiently warned to arouse suspicion, and when they either knew, or by the exercise of ordinary care should have known, that the affairs of the bank were being imperiled by Mr. Allis and his associates, and it follows from the rules of law, hereinbefore referred to, that the directors should be held liable for all losses that could have been prevented by a proper discharge by them of their duties after December 1, 1891. I need hardly add that I have reached this conclusion with great reluctance, because the neglect of a proper supervision of the bank was in a sense unintentional, and because many of the defendants have already sustained severe losses as stockholders and depositors; but, on the other hand, the court cannot ignore the rights of innocent third persons who confided in this bank, relying upon the protection which the names of these directors and a proper discharge of their duties held out to the public.

As to the statute of limitations, I have come to the conclusion that it does not apply, because the case in my opinion falls under the exceptional circumstances referred to by Sanborn, J., in Cooper v. Hill, . . . circumstances under which a court of equity will permit a suit to be maintained notwithstanding the statute . . . and also because at the time of the commission of the wrongful acts in question and afterwards, until the appointment of a receiver, the defendants who were concerned therein constituted a majority, if not the whole, of the board of directors, and that in consequence of their having full control of the corporation no suit could be brought to redress the alleged grievances until a receiver was appointed . . .

A special defense is set up by the executors of Logan H. Roots, deceased, on account of ill health and absence from the city, and in that connection Briggs v. Spaulding,[1] 141 U. S. 132, . . . has been referred to. I think a passing illness, temporary in character, is an excuse for the period it lasts, but, if a person becomes a

[1] For an extract of the case, see Ebersole, J. F., *op. cit.*, first edition, pp. 198–226.

confirmed invalid for a number of years and unable to attend to the duties of a director, he has no right to hold on to the position and at the same time decline its corresponding responsibilities. By doing so he invites others to trust the bank on the strength of his name, and in such case he ought to bear his share of the consequences growing out of such a dual situation. This is peculiarly applicable to Col. Roots because of his high reputation in the community and the great trust that was placed in him as a director, as abundantly appears from the evidence in this case. Nor does it appear from the evidence that Col. Roots was in fact such an invalid that he could not give any attention to the affairs of the bank. On the contrary, it appears that he attended 46 meetings in 1890; 38 in 1891; 48 in 1892, and 9 in January, 1893. He also in writing indorsed and approved the report of the examining committee of November 25, 1891, signed the letter to the Comptroller of January 16, 1892, was re-elected and accepted the office of president in January, 1893, and accepted the office of receiver for this bank when it closed. Defendant Blass in his testimony says:

Logan H. Roots attended the board meetings whenever he was in the city. Being an old bank man, he was counseled in all matters of the bank by myself and directors. He had access to the books and papers of the bank at all times as a director.

Several other directors and a number of witnesses testified that Logan H. Roots had been identified with the bank for many years; that he was a man of unusual business ability; that they saw no change in his mental capacity down to the last; and that they relied very largely on his advice. The situation is not like that of Charles T. Coit in Briggs v. Spaulding, *supra*. Mr. Coit proclaimed his sickness and inability to act by asking for and obtaining a year's leave of absence. The court held that he had a right to act upon this leave of absence, and that he should not be held responsible for what occurred during such absence. It is also urged in defense of Col. Roots that he was necessarily absent from Little Rock a great deal, and hence unable to attend many board meetings. The same defense is made on behalf of defendant Blass, who spent much of his time in trips to the east in connection with his mercantile business. But to permit this to operate as a defense in a case of this kind would be putting a premium on the failure to attend board meetings and a penalty on those who attend regularly.

The next question is: What should be the measure of damage in a case like this, and what the extent of liability of each party? The question is involved in complications and difficulties. Counsel have given the court no aid in this direction. The prayer in the bill of complaint is general in language. Nor has complainant's counsel suggested any definite theory on this subject, either in oral argument or brief. Nor, after a long search, have I been able to find analogous precedents throwing light on the situation as it presents itself in this case, so that the court is left to carve out a decree for itself according to what, to it, would appear to be right and just under the general principles of law heretofore announced as applied to the evidence in this case. It should be mentioned, however, in this connection, that the Circuit Court of Appeals of this circuit has in the case of Cooper v. Hill laid down this general rule that:

When a loss has been caused by the appropriation of the funds of a corporation to a purpose unauthorized by its charter, or by culpable negligence, or by a conversion of its funds, all the officers of the corporation who are chargeable with the fault which occasioned the loss are liable for the entire misappropriation, without regard to the degree of dereliction of which each is guilty.

An examination of the bill of complaint in this case has led me to the conclusion that it states a common-law cause of action for damages sustained by the bank by reason of losses caused by the negligence of the directors so far as improvident loans to Mr. Allis and his associates are concerned. But that in regard to improvident loans to the City Electric Railway Company, the McCarthy-Joyce Company, and the Press Printing Company, complainant has expressly limited the right of recovery to the excess over the 10% limitation imposed by the national bank act, viz., $50,000. . . .

I further find from the evidence that the terms of service of the present defendants as directors of the bank were as follows: N. Kupferle, Gus Blass, John W. Goodwin, and Logan H. Roots, served from June 2, 1890, and prior thereto, up to the close of the bank; Henry M. Cooper from October 19, 1891, to the close of the bank; H. G. Fleming from October 19, 1891, to January 23, 1893; Mark M. Cohn from June 2, 1890, and prior thereto, up to January 12, 1892; Charles T. Abeles from January 12, 1892, to the close of the bank; James Joyce from January 12, 1892, to January 10, 1893; P. K. Roots from June 2, 1890, to January 16th,

1891; C. M. Taylor from January 16, 1891, to November 6, 1891; and William Farrell from January 16, 1891, to November 28, 1891 . . .

As to dividends, I find that the last dividend declared January 10, 1893, was declared and paid contrary to the statutory restrictions, and that those defendants who were directors at that time are responsible for the amount thereof as funds improperly diverted from the assets of the bank.

In view of the premises, as hereinabove stated, the court now finds and adjudges that a decree should be entered against defendants Gus Blass, John W. Goodwin, H. G. Fleming, and the estates of Logan H. Roots, Nick Kupferle, and Henry M. Cooper, as follows: (1) For all losses sustained by the bank by reason of any increase in the amount of money loaned to or permitted to be drawn by Mr. Allis and his associates, viz., . . . after December 1, 1891, and up to February 1, 1893, when the bank closed. (2) For all losses sustained by the bank by reason of any money loaned to or permitted to be drawn by . . . since December 1, 1891, in excess of a total indebtedness of $50,000 on the part of either of said corporations; the liability on account of these three corporations being for such increase in excess only. (3) For any losses sustained by the bank by the declaration and payment of the dividend of January 10, 1893.

The court finds and adjudges that a decree should be entered against defendant Mark M. Cohn (1) for all losses sustained by the bank by reason of any increase in the amount of money loaned to or permitted to be drawn by Mr. Allis and his associates, being the persons hereinbefore designated as such in the decree against Gus Blass *et al.*, after December 1, 1891, and up to January 12, 1892, when defendant Cohn went out of office; (2) for all losses sustained by the bank by reason of any money loaned to or permitted to be drawn by . . . after December 1, 1891, and up to January 12, 1892, in excess of a total indebtedness of $50,000, on the part of either of said corporations, the liability on account of these three corporations being for such increase in excess only.

A director ought not to be held responsible for the conduct of the business of a bank from the very day of his election if he has not been a director theretofore, but the evidence shows that defendant Abeles was put on the discount committee at once, and he was present at the board meeting of February 13, 1892 (30

days after his election), when the directors manifested a very anxious state of mind about the bank's finances, and when the telegram from Mr. Allis was received concerning the negotiations of his speculative stocks in New York. I think this was sufficient warning to Mr. Abeles, and that his responsibility ought to begin on that day.

The court therefore finds and adjudges that a decree should be entered against defendant Charles T. Abeles, as follows: (1) For all losses sustained by the bank by reason of the increase, if any, in the amount of money loaned to or permitted to be drawn by Mr. Allis and his associates, being the persons hereinbefore designated as such in the decree against Gus Blass *et al.*, after February 13, 1892, and up to February 1, 1893, when the bank closed. (2) For all losses sustained by the bank by reason of any money loaned to or permitted to be drawn by . . . after February 13, 1892, in excess of a total indebtedness of $50,000 on the part of either of said parties; the liability on account of these three corporations being for such increase in excess only. (3) For any losses sustained by the bank by the declaration and payment of the dividend of January 10, 1893.

As to defendant Joyce, the evidence shows that the circumstances of his election and his relations to Mr. Allis and the bank were such that a 30-day period should be sufficient interval between election and responsibility for future management.

The court, therefore, finds and adjudges that a decree should be entered against defendant James Joyce, as follows: (1) For all losses sustained by the bank by reason of the increase, if any, in the amount of money loaned to or permitted to be drawn by Mr. Allis and his associates, being the persons heretofore designated as such, after February 12, 1892 (being 30 days after he was elected a director), and up to January 10, 1893, when he went out of office. (2) For all losses sustained by the bank by reason of any money loaned to or permitted to be drawn . . . between the 12th day of February, 1892, and January 10, 1893, when he went out of office, in excess of a total indebtedness of $50,000 on the part of either of said corporations; the liability on account of these three corporations being for such increase in excess only.

And the court finds and adjudges that under the evidence a decree should be entered in favor of the estates of C. M. Taylor and William Farrell, and defendant P. K. Roots, and that the bill should be dismissed as to them . . .

Describe general business conditions during the years prior to date of failure. Did these conditions cause the failure?

Should a bank director resign immediately upon being informed that the bank has losses to face? What other action may he take to protect himself from additional or further liability?

Are individual directors liable jointly or severally for the financial losses incurred by a board of directors?

Suggest reasons for the extraordinary turnover in membership of the board of directors of this bank.

What rule did the decision in this case establish as to the incidence of directors' liability?

GAMBLE v. BROWN

29 Fed. Rep., 2nd series, 366 (U. S. C. C. A., 1928)

DUTIES AND RESPONSIBILITIES OF DIRECTORS OF NATIONAL BANKS—CIVIL LIABILITY PERTAINING TO LOAN ADMINISTRATION

SOPER, District Judge.[1] On August 26, 1914, the First National Bank of Sutton, W. Va., closed its doors . . . It was discovered that the condition of the bank was due in large measure to acts of embezzlement and fraud committed by Homer H. Dean, the vice president, and to excessive and unwarranted loans made to him, to members of his family, and to a corporation of which he was the principal owner. He also owned or controlled a majority of the capital stock of the bank, which amounted to $50,000.

It transpired that the directors of the bank had taken little or no interest in its affairs, but had left its management almost exclusively to Dean himself. Accordingly, a bill of complaint was filed by the receiver on March 8, 1917, against the directors in office when the bank closed, and certain other defendants who had been directors in former years, charging that the bank's failure was due to their neglect . . .

. . . the directors were negligent in the following respects: (1) They failed to hold or attend monthly meetings of the board, as prescribed by the by-laws of the bank. (2) They failed to cause the affairs of the bank to be periodically examined and audited by a committee appointed by them under the by-laws. (3) They failed to cause the loans discounted by the bank to be passed upon by a discount committee, as required by the by-laws, and failed to pass upon the loans as a board. (4) They failed to require of H. H. Dean a bond for the faithful performance by him of his duties as vice president of the bank . . .

There were only two meetings of the board between January, 1914, when Dean took charge of the bank, and August, 1914, when his defaults were discovered. They were held in May and

[1] Portions of this case are omitted.

June, respectively. At neither was there a report of the loans made or business done by the bank, or an account of its assets and liabilities submitted. . .

For most purposes, the period under investigation begins on January 15, 1914, and ends on August 26, 1914. On the first date, the First National Bank of Sutton, W. Va., entered into an agreement with the Farmers' Bank & Trust Company of the same place, whereby the bank took over the business of the trust company and agreed to assume its liabilities in the amount of $203,-970.32. In consideration thereof, the bank received, amongst other assets, certain notes payable to the trust company, aggregating $169,619.71, a list of which was made up and was intended to be annexed to the agreement. The transaction was an important one, outside the ordinary routine of banking business. Moreover, in a sense Dean was on both sides of the transfer. On the one hand, he had acquired control of the stock of the bank, and had been chosen to manage its affairs; and, on the other, he was an interested party, because he had been the treasurer and active officer of the trust company, which was then about to retire from business. It needs no argument to show that, under these circumstances, the dictates of ordinary care required a careful examination of the assets which were offered to the bank as consideration for its assumption of substantial liabilities. The fact is too much reliance was placed upon Dean's integrity . . .

. . . On January 15, 1914, notes were exhibited to the assembled directors, who passed upon them to ascertain whether or not they were acceptable. H. H. Dean, O. O. Sutton, and A. M. Berry were appointed a committee of directors to examine the notes and other assets to be transferred. The notes were left in Dean's custody. It was understood that copies of the list of notes were to be made and attached to copies of the agreement, to be held by the contracting parties, and that a subsequent meeting of the board would be shortly held in order to perfect the details of the settlement. This meeting, however, was never held, and the list of notes was never attached to the agreement. What purported to be a copy of it was subsequently found by accident, after the failure of the bank, in the vaults of the trust company by the receiver thereof. The result was that there was no record in the bank, which showed in detail the particular notes which were transferred. The contract and the books of the bank merely specified the aggregate amount . . . They failed to exercise

ordinary business caution when they intrusted the custody of the transferred assets to an unbonded officer, himself personally interested in the items transferred. It was careless on their part not to hold a meeting subsequent to January 15, as they had determined, in order to ascertain whether the details of the transfer had been properly accomplished . . .

Summarizing our conclusions, we find that the following losses are chargeable to one or more of the directors. Interest should be added . . .

What additions are made, by the decision in this case, to the definition of directors' responsibility?

McROBERTS v. SPAULDING

32 Fed. Rep., 2nd series, 315 (U. S. Dist. Ct. 1929)

DUTIES AND RESPONSIBILITIES OF DIRECTORS OF NATIONAL BANKS—CIVIL LIABILITY PERTAINING TO LOAN ADMINISTRATION

DEWEY, District Judge.[1] This is a suit brought against certain directors of the Merchants' National Bank of Grinnell, Iowa, seeking recovery for loss alleged to have been sustained by the bank on account of negligently loaning money of the bank to parties claimed to have been insolvent at the time of such loans, and to recover on the alleged charge of loans made which were excessive under the prohibition of section 5200, U. S. R. S. . . .

The bank was incorporated in the year 1883, and, at the time the loans complained of were made, had a paid up capital stock of $100,000, and an unimpaired surplus of $100,000. And as far as the excess loans were concerned, the case was tried upon the theory that the largest amount which the bank could legally loan to any one person was $20,000. The bank was taken over by the Comptroller of the Currency November 1, 1924.

The common-law negligence, as charged against the defendants, is based, as has been said, upon the claim that the parties to whom money was loaned were insolvent. The difficulty in the claim of the plaintiff in this regard is the uncertainty of values during the years from 1921 to 1924, which was the very heart of the period of deflation of farm land values and values of all kinds in Iowa.

The evidence shows, and the court will take judicial notice of, the banking situation, and the method and manner of its conduct prior to the deflation period, which started about the year 1920. The surety for country banks in Iowa and the basis of credit is real estate. From the time of the Civil War up to the year 1920, real estate in Iowa had a standard and fixed valuation, increasing gradually, and a person engaged in farming in Iowa prior to 1920, if honest and industrious, was worthy of credit.

[1] Portions of this case are omitted.

And the banks in Iowa generally loaned such individuals money or extended them credit, based upon the amount of property which they owned; and if the borrowers had real estate, upon the amount of equity in the real estate owned by such individual borrower.

At about the time of the breaking out of the World War in 1914, farming operations in Iowa became very profitable, and during the period of the war there was a gradual advance in prices, and Iowa was rich and prosperous. After the close of the war this prosperity took on a turn of speculation, which continued to grow and expand until the Federal Reserve Bank finally decided to stop the speculation by demanding the withdrawal of its loans. From this time there was started in Iowa a period of depression and panic which depreciated the value of all property and caused real estate values to decline, making their true value uncertain, and so reduced, that farms were considered as having the value of a conservative first mortgage.

As shown by the evidence, when this period of depression started in 1920, and during the time until the closing of this bank, November 1, 1924, it was generally thought by bankers and business men that the period of depression was temporary, and that values of real estate, which during that time were uncertain, would soon reach a stability that would enable business to again be transacted as before upon sound real estate values.

In retrospection it is easy to criticize the actions of the officers of the two or three hundred banks in Iowa that failed, with being derelict in their duties and making improvident loans, and yet, during all of the period in which it is charged that these defendants were negligent in making loans to individuals that were insolvent, the banking department of the state of Iowa was encouraging banks to remain open, having their directors sign guarantees of bank loans, and using every effort to maintain the former business relations, in the hope and expectation that such values would again become sound and substantial, and thus prevent the closing of banks with resultant loss to stockholders and creditors.

We are not here considering an ordinary bank failure caused by the mismanagement of the directors, but a situation that was caused by extraneous circumstances and conditions that could not be foreseen and the extent of which reasonable men could not at the time anticipate. And where bank officers, as in this case,

made every reasonable effort to prevent the failure of their bank, they should not be criticized.

As shown by the testimony, other banks were following the same procedure as followed by the directors and officers in this case. It is stated in the case of Lyon v. Featherman, 80 Mont. 504, 512, 261 P. 268, 271: A director "cannot be held liable for losses on loans made in good faith at a time when any reasonably prudent banker would consider" them "for the best interest of the bank," even though in looking back they appear not to have been so. Directors are not liable for lawful loans made in good faith, although the making thereof was an error in judgment . . .

The question of improvident loans is not what some one else might think about a loan, but the question is what the directors in making the loans thought, and the method and motive by which they were controlled in their actions.

Testing the actions of the directors in this case by the above rules, and the facts and circumstances surrounding them at the time, this court cannot say that the directors were negligent in making the loans that they did make, and which are charged in the petition as having been made improvidently and carelessly by such directors.

The difficult question involved in the case is not that of common-law liability for negligence, but the charge that the defendants had knowledge of and assented to certain loans to individuals and a partnership which, in each case, were in excess of the limit which the banking laws of the United States permit any bank to loan to a person or partnership.

. . . The National Bank Acts in force at the time of the transactions herein involved, section 5200 U. S. R. S. . . .

. . . And Revised Statute 5239 . . . In accordance with the plain provisions of these sections, a director who participates in, or knowingly assents to an excessive loan, in this case over $20,000, is personally liable for the damages suffered thereby. And under the decisions of the Federal Supreme Court, in order to recover from a director for losses on an excessive loan, it must be shown that the defendant while director participated in or assented to the excessive loan; not through negligence merely, but knowingly, and, in effect, intentionally. Corsicana National Bank v. Johnson . . .

In this case the plaintiff seeks to recover the full amount due from the borrower as shown by the books of the bank at the time it closed its doors[1] on November 1, 1924. But the defense claims, and the court feels rightfully so, that a renewal and consolidation of former loans does not constitute a new and single transaction. . . . The inference in this case being that, if, in good faith and in the ordinary course of business, the defendants made a loan equal to the amount authorized, and later, while this loan remained unpaid, as a separate transaction, unlawfully loaned additional money in excess of the prescribed limit, the damage legally attributable to their violation of the limiting provisions would be the amount of the excess loan, and not the full amount . . .

The question also arises, and it is claimed by the plaintiff, that, where several loans are made to an individual for money borrowed from the bank, and later these notes are taken up and a new note given, constituting a renewal for the amounts already owed, this would constitute a new loan, and the directors involved would be liable for the full amount thereof as damages. The court is satisfied that this is not the true rule, but that the court should look beyond the giving of notes in any particular case to find out what was the real and true transaction . . .

A renewal is not a loan, it is an extension of time of payment . . .

Describe the economic conditions prevailing in the agricultural sections of the Middle West during the five years preceding the closing of this bank. Is it apparent that the fixing of responsibility for making loans should be modified by developments in general business conditions? Did the court give weight to such external conditions?

What is the measure of directors' liability for making excess loans? What was the court's definition of an excess loan?

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[1] For a discussion of the civil liability of executive officers and directors, after sale of a bank, for violations of law during their administration, see case of Corsicana National Bank of Corsicana v. Johnson, Ebersole, J. F., *op. cit.*, first edition, pp. 253–264.

STOUT v. UNITED STATES

227 Fed. Rep. 799 (U. S. C. C. A. 1915)

DUTIES AND RESPONSIBILITIES OF EXECUTIVE OFFICERS OF NATIONAL BANKS—CRIMINAL LIABILITY PERTAINING TO LOAN ADMINISTRATION

HOOK, Circuit Judge.[1] Stout was convicted and sentenced for misapplying the moneys and credits of the First National Bank of Cherokee, Okl., of which he was president, to the use and benefit of the Cherokee Mill & Elevator Company. Rev. St. Section 5209 (Comp. St. 1913, Section 9772).

. . . In the prolixity of words there is plainly discernible the substance of a charge that the accused, whilst president of the bank and by use of the authority of his position, loaned its funds to the mill company, which was known by him to be hopelessly insolvent, not so known to the bank or its directors, and under circumstances naturally leading to the loss of the money loaned, and so resulting—all with intent to injure and defraud the bank.

. . . We think there was substantial evidence of all the essential facts of the case against the accused . . . This was particularly so as to the ignorance of the directors of the bank of the financial condition of the mill company to which the bank's funds were loaned, its hopeless insolvency, the true nature of the loans made by the accused, including the one set forth in the fifth count of the indictment, that they were not intended as bills of exchange on which the drawers were to be held, and were not being secured either by mortgage bonds of the mill company, as represented by the accused, or by warehouse or elevator receipts, or by grain or flour held for the purpose. On the other hand, there was no doubt but that the accused was fully informed of the conditions which signified certain ultimate loss to the bank. The jury might well have been convinced that he exercised in fact a dominating control over the business of the bank, and also had much actively to do with the finances of the mill company by way of obtaining loans for it both from his bank and also

[1] Portions of this case are omitted.

from other sources from which he secretly received personal compensation. They were also justified in finding the requisite willful, unlawful intent from evidence of his reckless disregard of the bank's interests and welfare and his deception of the directors, in some instances by suppression of the facts and in others by misrepresentations as to the financial condition of the mill company and the security for the loans. There was much testimony on those matters, and the jury were warranted in believing it. One trouble with the arguments for the accused is in the failure to distinguish between the power and the responsibilities of one occupying a position of trust . . .

Undoubtedly the directors knew the loans were being made upon so-called bills of exchange with wheat tickets attached indicating the amount of wheat purchased by the Mill Company. But there was evidence that it was the accused, not the directors, who established the custom referred to, that he alone knew the Mill Company was insolvent, that it was not keeping the wheat in its mill or elevators, or the flour product, as security for the loans, and that in fact the loans were wholly unsecured. There was also evidence that he purposely refrained from informing the directors of the true condition, and in some instances expressly misrepresented it to them. Under these circumstances the knowledge of the directors of the custom and the apparent form of the loans, and their reliance upon the semblance of security which did not in fact exist, would not relieve the accused . . .

The sentence is affirmed.

25. BANK BUILDING

MERCHANTS TRUST COMPANY

ERECTION OF A NEW BANK BUILDING[1]

The Merchants Trust Company was established in 1909 in a New York State city of 80,000 inhabitants. The trust company occupied leased quarters on the first and second floors of an office building situated in the center of the business district. In 1909 the Merchants Trust Company was the only trust company in the city; the other five banks were national banks. The trust company immediately initiated a new business campaign, to acquaint the residents of the city with the advantages of appointing the trust company as an executor and trustee of estates and as an agent in other capacities in which the law authorized trust companies to act. The trust business developed slowly and, although the company had been named as trustee in a number of wills, the trust business in 1925 amounted to only $3,000,000. It was expected that this amount eventually would be increased to $15,000,000.

The trust company also had developed a commercial and a savings department, and, in the period 1909 to 1925, these two departments grew more rapidly than the trust business. In 1925 total deposits exceeded $8,000,000, and depositors, including those in the savings department, numbered 18,000. The growth of the commercial department was due in a large measure to the trust company's efforts in securing small accounts which never had been given adequate service by the other banks. The main items in the balance sheet of the trust company, as of June 30, 1925, were: Capital, $500,000; Surplus and Undivided profits, $621,736; Deposits, $8,498,909; Loans and Discounts, $7,684,392;

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[1] See: *The Architectural Forum* (Bank Reference Number) June, 1923, especially Sawyer, Philip, "The Planning of Banks," pp. 263–272, Abell, E. F., "The Layout and Equipment of Banks," pp. 273–276, Taylor, C. S., "Economic Considerations in Bank Planning," pp. 281–282, Ball, W. J., "The Individual Bank Building," pp. 293–296; Hopf, H. A., *Planning the Bank Building* (a series of three articles reprinted from *The Bankers Monthly*); Hopkins, Alfred, *The Fundamentals of Good Bank Building.*

Bonds and Other Securities, \$1,894,623; Cash, \$946,521. The population of the city at that time was estimated at 130,000.

In July, 1925, the subject of new bank quarters, which the Merchants Trust Company had had under consideration for some time, was discussed at a meeting of the board of directors. It was stated that the company had outgrown its quarters, and that it did not have sufficient space for the comfortable accommodation of its customers or the efficient conduct of its business. An increase in the business of all departments was expected, and additional space would have to be secured by the bank within a short period.

Mr. Watson, one of the oldest and most conservative directors, advocated that efforts be made to secure office space on the third and fourth floors of the building then occupied. He argued that complete removal from the present quarters was unnecessary, and that it might even result in some loss of goodwill. He believed that depositors and customers of a trust department are influenced by the character of a bank's officers and directors, the soundness of the financial condition, and the services rendered, rather than by spacious and elaborate banking quarters. Other directors, however, were strongly opposed to this attitude. They felt that the rent which the trust company paid was already high, that a new lease for the third and fourth floors could be obtained only at a proportionately higher figure, and that it was no longer wise to be at the mercy of outsiders who, by refusing to renew the lease at a reasonable figure, or at any figure, upon its expiration on September 1, 1927, could greatly inconvenience the trust company. Therefore, they advocated the purchase of an available site five blocks distant, but in the logical direction of the growth of the business district, and the erection thereon of a bank building.

The chief proponent of the new building was Mr. Lawson. He was a prominent manufacturer and was active in various organizations, such as the local Chamber of Commerce and the Rotary Club. He pointed out that the trust company's principal competitor, the First National Bank, had just completed a new bank building, and stated that, as a result, the First National Bank enjoyed a distinct advantage over the trust company in securing new business. He believed this fact to be especially true of the trust business, for which impressive quarters give an atmosphere of moral worth and financial stability. He stated also that considera-

tions of civic pride should lead the directors to decide in favor of a new building, and that a well-designed building not only would increase the prestige of the Merchants Trust Company, but also would be a distinct addition to the architectural beauty of the business section of the city.

A new building of the type desired, including purchase price of the land, would cost about $980,000. This building would be of the fifth-century Greek style and would be much larger than the present needs of the trust company required. After considerable discussion, the directors voted to expend $1,000,000 for the purchase of land and the erection of a building.

Outline briefly a method for, and the considerations to be covered in, forecasting the growth of this bank and its needs for space.

How much weight should be given to such prospective factors as: (*a*) consolidations, (*b*) failures, and (*c*) building projects, of local banks?

How many years' growth should be provided for in the immediate construction plan?

Was July, 1925, a good time to build? Should this bank be criticized for having a lease expiring in 1927?

Canvass the arguments for and against construction of (*a*) a special-purpose, ornate bank building, and (*b*) a general-purpose office building with first-floor banking quarters.

Should a bank follow or anticipate the trend of movement of office buildings in selecting a location for a new building?

How much should this particular bank invest in a building project, consideration being given solely to its published net worth? Should it consider a plan for financing part or all of the building cost by the use of outside capital?

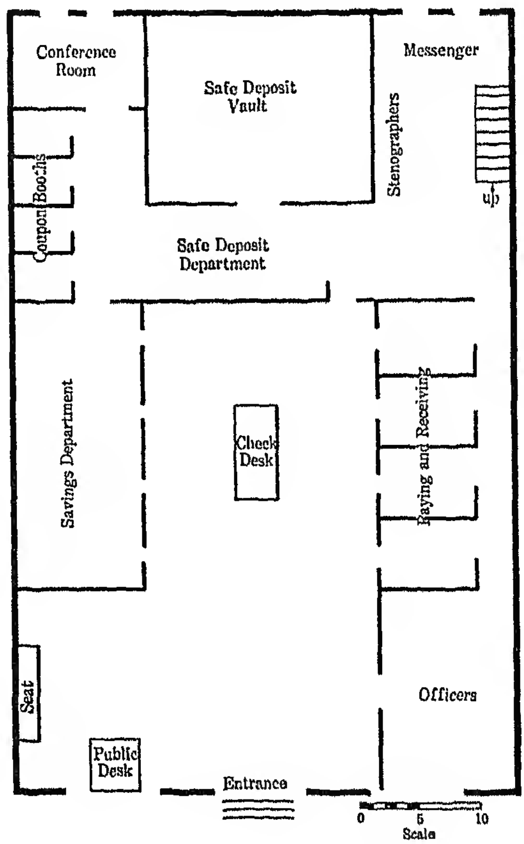
BARFIELD TRUST AND SAVINGS BANK

LAYOUT OF MAIN BANKING ROOM

The Barfield Trust and Savings Bank, an institution with a capital and surplus in excess of $4,000,000, was located in the

EXHIBIT I

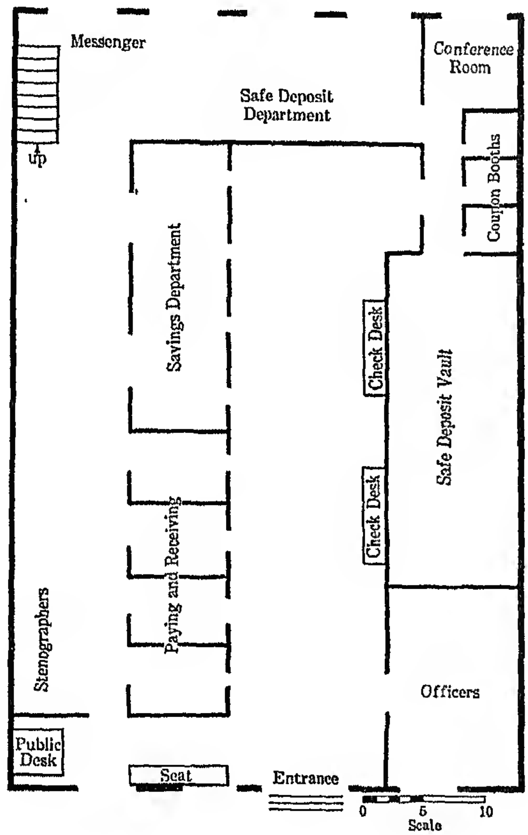
First-floor Plan



downtown financial district of Philadelphia. During 1925 the board of directors of the bank became convinced that it would be desirable to establish a branch in one of the city's suburban

business centers which served a growing middle-class residential section. With this end in view, the Barfield Trust and Savings Bank purchased an inside lot on the main street leading through the section in question, with a frontage of 42 feet and a depth

EXHIBIT 2
First-floor Plan



of 65 feet. The board of directors planned to erect a two-story building on this plot, the banking room and safe deposit vault to occupy the ground floor, leaving the upper floor for clerk space and locker rooms.

The directors of the Barfield Trust and Savings Bank believed that four paying and receiving tellers' cages would be ample to

care for the commercial accounts which could be expected to come into the new branch. They felt, however, that more extensive facilities should be provided for handling savings and safe deposit business. Consequently, in calling for architects' drawings of the banking floor, they stipulated that the savings department should have a four-place counter, and that several coupon booths should be provided for the use of customers having safe deposit boxes.

In accordance with the wishes of the board of directors, the architect whose services had been engaged submitted the two first-floor plans shown in Exhibits 1 and 2.

Criticize the plans for the proposed branch of the Barfield Trust and Savings Bank from the points of view of maximum utilization of space, convenience of customers, convenience and efficiency of working force, possibility of future expansion, and existence or appearance of congestion in the public space.

Can more units of work per square foot of space be obtained by having one or two clerks (one an assistant) in a single teller's cage? How wide should a teller's cage be? Should banks abolish all tellers' cages, making banks less forbidding to customers?

Which plan affords the greatest amount of protection to the bank, and to the customers therein, when and if a "hold up" is attempted during banking hours?

Which of the two plans is preferable? Would the answer be the same for an independent bank as for a branch of the Barfield Trust and Savings Bank?

26. BANK PERSONNEL

WHITMORE NATIONAL BANK

THE PERSONNEL DEPARTMENT AND ITS RELATION TO TURNOVER OF WORKING FORCE[1]

Curtailment in the volume of business, as well as in earnings, of commercial banks during the first nine months of 1930, made drastic reductions expedient in the clerical forces of these banks. The Whitmore National Bank, located in a large eastern city, had deposits of over $450,000,000 and a staff of 1,701 employees, on December 31, 1929. The bank had found it advisable to dismiss 154 competent persons between January 1 and September 30, 1930, solely in order to adjust the staff to the volume of work and to cut down expenses. This number, when added to the 247 employees who had left the bank or had been discharged for other reasons during the same nine months, brought the total turnover of working force for the nine months' period up to more than 23% of the number employed at the end of 1929.

It had been the considered policy of the Whitmore National Bank to develop a loyal and satisfied body of employees. The bank had been one of the pioneers in personnel work in its city; in 1930 it had a large and carefully organized department in which were centralized the functions of employment and employee supervision and welfare. The various operations performed in this personnel department are sketched in Exhibit 1.

The care with which the bank chose its employees and the consideration which it gave them after employment are revealed by excerpts from the personnel department's manual of procedure, which are reproduced in Exhibit 2.

When the turnover statistics for the first nine months of 1930, which are shown in Exhibit 3, were released by the personnel research director, one of the senior officers of the bank, Mr. Hardy, stated his opinion that these figures conclusively proved the futility and wastefulness of personnel work. While he was willing

[1] See: Davis, Eleanor, *Personnel Programs in Banks;* Philp, W. G., *A Personnel Study of Colorado Bank Executives*, University of Colorado Business Bulletin No. 39; American Bankers Association, *Commercial Bank Management Booklet No. 8, Man Power in Banking Institutions*, and *Commercial Bank Management Booklet No. 16, Educational Policies in the Training of Bank Employees.*

EXHIBIT 1

Personnel Department

General Supervision—Vice President in Charge

I. Operating Direction of Personnel Activities.
  (A) Employment.
    1. Develop sources of labor supply.
    2. Select and place new employees.
    3. Investigate employees before hiring.
    4. Arrange replacement training.
  (B) Contact.
    1. Advise department heads on policies and methods.
    2. Relate salaries to market rates and difficulty of work.
    3. Stimulate the development and progress of individual employees.
    4. Administer policies in regard to vacations, retirement, etc.
    5. Confer regarding the personal problems of employees.
    6. Detect and help to eliminate grievances.
  (C) Employee Services.
    1. Provide health service.
      (a) Secure proper working conditions and guard against illness.
      (b) Pass upon and follow up reports of physical examinations.
    2. Furnish insurance protection.
    3. Facilitate regular employee saving.
    4. Make employee loans.

II. Research and Development.
  (A) Records.
    1. Employee records.
      (a) Employment.
      (b) Salary history.
      (c) Labor turnover.
    2. Service records.
      (a) Health.
      (b) Group insurance.
      (c) Savings plan.
      (d) Loan account.
    3. Business references for former employees.
  (B) Research and Coordination.
    1. Study the internal personnel problems of the bank and the practices of other institutions.
    2. Establish personnel policies.
  (C) Development.
    1. Conduct educational program among employees.
    2. Make contacts with schools and colleges.
    3. Prepare manuals for the employees of the various departments describing the work of those departments.

to admit that 1930 was an unusual year, Mr. Hardy maintained that when a bank lost one-quarter of its employees during any nine months' period, regardless of conditions, it was ample justification for hiring the cheapest clerical workers that could be obtained and exploiting them to the utmost for whatever period they chose to remain in the bank's employ. He believed that the experience of the Whitmore National Bank proved that a large turnover

EXHIBIT 2

Excerpts from the Personnel Department's Manual of Procedure

I. Sources of Employees (in order of their importance).

1. Local high schools, which are visited by a representative of the personnel department shortly before graduation dates.
2. Selected colleges, with which contacts are also made by the personnel department.
3. Selected employment agencies.
4. Direct applicants.
5. Newspaper advertisements.

II. Interview.

1. During the interview the applicant is appraised as to appearance, personality, ability, and experience.
2. The interviewer covers the following points:
   - (a) Department in which vacancy exists.
   - (b) Requirements of the job.
   - (c) Approximate salary.
   - (d) Hours of work.

III. Application Blank.

Situation desired — Date
Name — Phone
Present address
Previous address
Place of birth — Date
If foreign: When did you come to the United States
When did you become a citizen
Are you married — Is your { husband living with you / wife " " " }
Number of children — Other dependents
Do you own your home, rent, or board
Father's business
Amount and particulars of any private income
Are you in debt — If so, how much and for what reason
Has your application for a surety bond ever been refused
What church do you attend — Address
Salary expected — What date could you begin
Are you related to an officer, director, or employee of this bank
If so, to whom

Educational Record

Attendance Dates	Name of School	Address	Did you Graduate	Remarks

Business Record

Employed From	To	Employer	Address	Position Held	Reason for Leaving

References Other than Relatives and Former Employers

Name	Occupation	Address

IV. Investigation.—Investigators of the personnel department make detailed reports on each applicant, which are checked against the information given on the application blank. Reports are prepared with reference to home background and church recommendation, school records, employment dates, and other information not given on the application blank.

EXHIBIT 2. (*Continued*)

Letters are sent to personal references for a statement of character, and to business references for information regarding the applicant's ability and integrity.

Each successful applicant is given a physical examination before being put to work.

V. Records.

(A) Personal File.—When a person reports for work, the following records concerning him will be placed in an individual folder and kept on file in the personnel department:

(a) Reference letters, both personal and business.
(b) Report on home investigation.
(c) Application blank.
(d) Miscellaneous correspondence and reports.
(e) Periodic reports by superiors.

(B) Periodic Reports.—Twice each year department heads or their assistants prepare reports on each employee under their supervision, on the form reproduced below:

Name Nature of Duties Department

(Rating Symbols to be Used: A, Exceptional; B, Above Average; C, Average; D, Below Average)

1. Personal Characteristics.
   - Health
   - Appearance
   - Attendance
   - Punctuality
   - Courtesy and tact
   - Ability to meet the public
2. Demonstrated Ability.
   - Speed
   - Quality of work
   - Reliability of work
   - Interest in work
   - Initiative
   - Cooperation
3. Possible Development.
   - Suitability for present work
   - Other work, if any, for which more suited
   - Other work for which trained
   - Capacity for assuming responsibility
   - Outstanding characteristics which make employee valuable:
     - To the department
     - To the bank in general
   - Traits which appear to hinder development
4. Fill out if work is of a specialized or executive nature:
   - Resourcefulness
   - Leadership
   - Management
   - Training of employees
   - Special aptitude for
   - Special training in
   - Advancement possible as:
     - Organizer Leader Individual worker
5. Additional Comments and Recommendation Regarding Salary:

   Signature of Superior

6. Action Taken.—On (date) the attention of this employee was called to his (her) good qualifications and counsel was given on those needing improvement.

   Result of interview:

   Signature of Personnel Department Representative

VI. Salaries.

1. Initial Salaries.—Determined by market conditions, range of salaries paid for similar work, last salary received, age, experience, and special considerations, such as educational background.

EXHIBIT 2. (*Continued*)

2. Salary Adjustments.—The salaries of all employees will be reviewed at least once a year, and more frequently in the case of new members of the staff. The immediate supervisor is responsible for the recognition of each individual's service, but the personnel department sees that no one is overlooked.

   Adjustments may be initiated and put into effect at any time.

   Amount and date of last increase and proximity of present salary to the maximum paid for similar work will be considered, in addition to the individual's own record, in determining whether or not an increase in salary will be granted.

VII. Education.—The bank conducts a free training school for machine bookkeepers. Other inexperienced employees are trained on the job.

   The bank encourages outside study and will refund one-half of the tuition fees to any employee who completes successfully courses of the American Institute of Banking or of other schools, provided that approval was given by the personnel department before the courses were begun.

VIII. Miscellaneous.—Group insurance is carried by the bank, employee saving is encouraged and facilitated, and loans to employees are made through the Personnel Department.

   Efforts are made at all times to secure the best possible working conditions and to eliminate grievances of every sort.

EXHIBIT 3

Turnover Statistics, January 1 to September 30, 1930*

	Number on Payroll Dec. 31, 1929	Per Cent	Separations	Per Cent	Ratio of Separations to Number on Payroll Dec. 31, 1929
Men	971	57.1	225	56.1	23.2%
Women	730	42.9	176	43.9	24.1
Total	1,701	100.0	401	100.0	23.6%

Separations Classified According to Divisions

Division	Men	Per Cent	Women	Per Cent	Total	Per Cent
Deposit	89	39.6	49	27.8	138	34.4
Credit—Loan	11	4.9	14	8.0	25	6.2
Foreign Exchange	6	2.7	1	.6	7	1.8
Investment Service	11	4.9	8	4.5	19	4.7
Trust	37	16.4	47	26.7	84	21.0
Business Extension	5	2.2	9	5.1	14	3.5
Interior Service	66	29.3	48	27.3	114	28.4
Total	225	100.0	176	100.0	401	100.0

*In computing percentages, major fractions have been treated as units except where adjustments are necessary to make the total 100; in the majority of cases adjustment has been made in the figure causing the least error.

EXHIBIT 3. (*Continued*)

Separations Classified According to Salary Range

Monthly Salary Range	Men	Per Cent	Women	Per Cent	Total	Per Cent
Less than $100	66	29.3	67	38.1	133	33.2
$100–$125	59	26.2	72	40.9	131	32.7
$126–$150	44	19.6	27	15.4	71	17.7
$151–$200	27	12.0	8	4.5	35	8.7
$201–$250	11	4.9	2	1.1	13	3.2
$251–$300	7	3.1	...	....	7	1.8
$301 and Over	11	4.9	...	....	11	2.7
Total	225	100.0	176	100.0	401	100.0

Separations Classified According to Age

Age	Men	Per Cent	Women	Per Cent	Total	Per Cent
14–20	62	27.6	55	31.3	117	29.2
21–25	71	31.6	74	42.0	145	36.1
26–30	26	11.5	33	18.8	59	14.7
31–35	13	5.8	9	5.1	22	5.5
36–40	9	4.0	1	.6	10	2.5
41–50	18	8.0	2	1.1	20	5.0
51 and Over	26	11.5	2	1.1	28	7.0
Total	225	100.0	176	100.0	401	100.0

Separations Classified According to Length of Service

Length of Service	Men	Per Cent	Women	Per Cent	Total	Per Cent
Less than 6 Months	58	25.8	39	22.2	97	24.2
6 Months–1 Year	35	15.5	40	22.8	75	18.7
1 Year–2 Years	55	24.5	47	26.7	102	25.4
2 Years–3 Years	15	6.6	17	9.6	32	8.0
3 Years–4 Years	8	3.6	9	5.1	17	4.2
4 Years–5 Years	7	3.1	8	4.5	15	3.8
5 Years and Over	47	20.9	16	9.1	63	15.7
Total	225	100.0	176	100.0	401	100.0

EXHIBIT 3. (*Continued*)

Separations Classified According to Reason

Reason	Men	Per Cent	Women	Per Cent	Total	Per Cent
Ill Health	9	4.0	7	4.0	16	4.0
To Be Married	...	....	9	5.1	9	2.2
Leaving Town	7	3.1	12	6.8	19	4.7
To Remain at Home	1	.5	25	14.2	26	6.5
To Return to School	15	6.6	6	3.4	21	5.2
Deceased	4	1.8	...	....	4	1.0
Dishonesty	1	.5	...	....	1	.3
Insubordination	1	.5	...	....	1	.3
Infraction of Rules	2	.9	1	.6	3	.8
Incompetent	35	15.5	12	6.8	47	11.7
Absence or Lateness	12	5.3	7	4.0	19	4.7
Dissatisfied	14	6.2	9	5.1	23	5.7
New Position	27	12.0	17	9.6	44	11.0
Reduction of Staff	85	37.8	69	39.2	154	38.4
Unsatisfactory References	2	.9	1	.6	3	.8
Pensioned	10	4.4	1	.6	11	2.7
Total	225	100.0	176	100.0	401	100.0

in the working force was inevitable, in spite of all the precautions which might be taken to prevent it, and, consequently, that the money spent in hiring and training employees[1] and promoting their welfare was, to a large extent, wasted.

Can the personnel department of the Whitmore National Bank, in the long run, save its costs by producing a more efficient and less expensive staff of employees? Why?

Why is personnel work in commercial banks not as highly developed as in industrial companies? Should one favor job studies in commercial banks?

Do the turnover statistics of the Whitmore National Bank present an argument against hiring young workers and paying them low salaries?

Were the conditions prevailing in 1930 such as would tend to increase or decrease the number of separations attributed to reasons other than "Reduction of Staff"?

[1] The Whitmore National Bank had no exact figures on the cost of training employees, except in the case of machine bookkeepers, who could be adequately trained in the bank's special classes at a cost of $300 each, and who were given starting salaries of $75 a month on completion of this course. The bank, however, had arrived at $30 as the cost of hiring each new employee, this figure covering expenses incurred in investigating the applicant, giving a physical examination, and building up a personal file. Mr. Hardy pointed out that this hiring expense alone had amounted to over $12,000 for the 401 employees who left the bank during the first nine months of 1930.

DIGBY NATIONAL BANK

BANK SALARIES

The Digby National Bank, a large New York City institution, in common with other banks, had suffered from the adverse business conditions prevailing during the final quarter of 1929 and the first nine months of 1930. Late in 1929 the bank had discharged a considerable number of employees, increasing its staff again when business picked up during the first part of 1930. By early fall, however, it became evident that the decline in activity which had taken place during the summer was not merely seasonal, and that every effort should be made to reduce the bank's expenses.

The junior officer in charge of the personnel department of the Digby National Bank did not wish to throw employees out of work under the conditions prevailing in the New York labor market in the fall of 1930,[1] unless it proved absolutely necessary to do

[1] The National Employment Exchange, in its October, 1930, *Current Conditions*, stated:

"The July-September quarter recorded a heavy further shrinkage in the demand for office workers in the Metropolitan District.

"New low points were reached in July and August successively. September brought a flurry of calls in the low-salaried clerical brackets, occasioned largely by juniors returning to school—otherwise a third successive low might have been touched. Compared with the corresponding quarter of last year, employment requisitions were off over 75%, only 24 workers being asked for this year where 100 were needed in 1929.

"The annual fall pick-up has not materialized, but a slightly better demand in the above-junior classifications during the opening week of October may be a straw showing which way the business wind is blowing.

"The market index figures for the past recent months tell the story of the difficulties which white-collar workers have been experiencing in finding employment."

Market Index, Number of Registrants vs. Each 100 Positions Listed, 1930.

Month	Men	Women
January	657	610
February	1,416	782
March	1,287	730
April	1,000	695
May	912	748
June	1,407	887
July	1,681	724
August	1,955	865
September	2,130	1,400

so. The only alternative was a general reduction of the salaries of the members of the bank's staff. In order to make an intelligent decision as to which of these possible courses to follow, the personnel department ascertained the going rates at which employees could be hired, as shown in Exhibit 1. These rates were compared with the salaries paid by the Digby National Bank, and the grouping of the bank's employees by length of service was studied in order to determine what persons might justifiably be dismissed if such action were necessary. The statistics relating to the bank's own staff were compiled semiannually for both men and women. The June 30, 1930, figures for men on the staff, which are reproduced in Exhibit 2, were considered representative, since the bank had comparatively few women employees.

At the conclusion of the study of this problem, members of the personnel department were divided on the action which should be taken. One group maintained that, in the light of current salaries as reported by the National Employment Exchange, the bank was overpaying its employees. They pointed out that clerical workers of average experience could be secured in almost any department for between $1,200 and $1,800 a year, whereas the Digby National Bank was paying $1,500 or over to about half of the men who had been with it for five years or less. They contended that prevailing conditions and the fact that the bank had paid liberally in the past would induce even the most valuable employees to accept a substantial reduction in their salaries, without seriously affecting their loyalty or happiness in their jobs. Finally, they argued against releasing employees, on the ground that business could not remain depressed for many more months. They held that it would be better to maintain intact, at some immediate loss although at reduced salaries, a staff which was acquainted with the methods and standards of the bank, than to incur the expense of hiring and training a large number of new workers when the upturn in business should come.

Other members of the personnel department took the opposite view. They argued that the logical procedure would be to cut the number of employees to the minimum, retaining only the head clerks and most efficient subordinates, with no reduction in the salaries of such men. They defended this plan by stating that the curtailed volume of business being done by the bank made it feasible, and that it would result in the greatest possible savings; they contended, furthermore, that it would increase the loyalty

EXHIBIT 1

Annual Salary Scale at Current Market, October, 1930
Men—Bank and Trust Company Classification*

Position	Brief or No Experience	Average Experience	Specialized Experience
Auditing and Bookkeeping Division			
Senior Auditors	....	$2,000–2,600†	$2,800–3,600†
Junior Auditors	$1,500–1,800†	....	....
General Bookkeepers	....	1,800–2,200†	2,200–2,600†
Machine Operators	1,000–1,300†	1,400–1,600†	1,800†
Loan and Discount Division			
Senior Clerks	....	1,800–2,400†	2,400–3,000‡
Clerks	1,400–1,600†	1,800–2,000†	....
Rack Division			
Head Clerks	....	1,800†	....
Clerks	1,000–1,200†	1,200–1,500†	....
Transit Clerks	1,000–1,300†	1,300–1,500†	....
Proof Clerks	....	1,000–1,300†	....
Teller's Division			
Head Tellers	....	1,800–2,500†	3,000†
Paying and Receiving—Heavy	1,500–1,800†	2,000–2,200†	2,400†
Receiving Tellers	1,300–1,500†	1,500–1,600†	1,800†
Note Tellers	1,300–1,500†	1,800–2,000†	2,200†
Foreign Tellers	1,500–1,800†	1,800–2,200†	2,400†
Assistant Tellers	....	1,300–1,500†	....
Signature Clerks	....	1,500–1,800†	2,000†
Certification	1,200–1,500†	1,500–1,800†	....
Collection	1,300–1,500†	1,500–1,800†	....
Security Division			
Bookkeepers	1,300–1,500†	1,500–1,800†	1,800–2,200†
Junior Clerks	1,000–1,300†	1,300–1,400†	1,500–1,600†
Stock Transfer Clerks	1,000–1,500†	1,500–1,800†	....
Window Clerks	....	1,800–2,000†	2,400†
Trust Division			
Senior Trust Officials§	....	3,000–5,000†	Open‡
Junior Trust Officials	1,300–1,800†	2,000–2,400†	Open‡
Bookkeepers	1,200–1,500†	1,500–1,800†	....
New Business Correspondents	1,500–2,100†	2,200–2,500†	3,000†
Clerks	1,000–1,500†	1,500–1,800†	....
Foreign Division			
General Bookkeepers	1,400–1,800†	1,800†	1,800–2,200†
Credit Investigators	1,500–1,800†	1,800–2,000†	2,200–2,400†
Foreign Exchange Clerks	1,000–1,500†	1,500–1,800†	2,000†
Foreign Collection Clerks	1,200–1,500†	1,500–1,800†	2,000†
Miscellaneous			
Assistant Branch Managers	2,000–2,500†	3,000 up†	Open†
Chief Clerks	2,000–2,500†	2,500–3,000†	3,000 up†
Safe Deposit Managers	1,500–1,800†	2,000–2,400†	2,500 up†
Vault Men	1,300–1,500‡	1,800†	2,100†
Guards (Age 30–50)	1,200–1,400†	1,400–1,500†	....
Messengers (Age 30–50)	....	1,200–1,500†	....

* Source: National Employment Exchange, *Current Conditions*, October, 1930.
† Surplus of candidates.
‡ Supply in fair balance to jobs.
§ Senior trust officials may or may not have officers' titles, depending on the policy of the particular bank. Their duties are to consult with customers of the trust department and to sell the services of that department.
‖ Limited supply.
¶ Pronounced shortage.

EXHIBIT 2

Monthly Salaries of Officers and Men on the Staff, Grouped According to Length of Service, as of June 30, 1930

Length of Service	Staff										Officers
	Less than $100	$100–$125	$126–$150	$151–$200	$201–$250	$251–$300	$301–$350	$351–$400	$401 and over	Total	All over $401
Less than 6 Months..	34	44	18	23	5	3	1	..	2	130	..
6 Months–1 Year...	16	11	9	3	2	3	2	1	4	51	..
1 Year............	44	20	18	7	2	..	1	1	2	95	..
2 Years...........	17	15	7	7	3	1	..	..	1	51	2
3 Years	9	17	6	11	2	..	1	..	1	47	1
4 Years...........	2	14	8	12	3	3	1	..	..	43	2
5 Years......... ..	1	11	8	11	3	1	..	..	1	36	3
6 Years	.	6	10	14	5	2	1	..	1	39	
7 Years...........	..	2	12	8	2	1	1	1	..	27	
8 Years......... ..	..	2	4	2	2	1	1	..	1	13	14
9 Years...........	1	8	8	8	8	2	2	1	1	39	
10 Years..........	..	3	5	6	7	1	1	1	..	24	
11 Years....... ...	1	3	1	11	8	2	1	1	..	28	
12 Years.......	..	6	1	7	9	3	1	1	1	29	
13 Years........ ...	..	1	1	1	6	3	1	1	1	15	10
14 Years......	..	..	..	..	2	1	..	..	..	3	
15 Years......... .	..	1	1	2	2	2	1	1	..	10	
16 Years..........	..	..	1	1	1	1	..	..	..	4	
17 Years.......	..	.	1	2	1	2	1	..	1	8	
18 Years..........	..	1	1	1	2	1	..	1	..	7	7
19 Years..........	..	..	1	2	2	..	..	..	..	5	
20 Years....... ...	..	..	1	1	1	..	..	..	..	3	
21 Years..........	..	..	1	1	2	1	..	..	..	5	
22 Years....... ...	..	..	1	1	5	1	1	..	..	9	
23 Years..........	..	..	1	1	..	1	1	1	..	5	5
24 Years..........	..	..	..	1	2	1	1	..	..	5	
25 Years.......	..	..	..	1	2	1	1	..	..	5	
26 Years..........	..	..	1	1	1	1	..	.	..	4	
27 Years....... ...	..	1	1	..	1	..	..	1	..	4	
28 Years..........	..	..	..	..	..	..	1	..	..	1	4
29 Years..........	..	..	.	1	2	1	1	..	..	5	
30 Years..........	..	..	1	1	..	1	..	1	..	4	
31 Years..........	..	..	..	1	..	1	..	..	..	2	
33 Years..........	..	..	..	1	..	1	..	..	..	2	
35 Years..........	..	..	..	..	..	..	..	1	1	2	
36 Years..........	..	..	1	..	..	..	..	..	..	1	
37 Years..........	..	..	..	1	1	..	..	..	..	2	
39 Years..........	..	..	..	..	..	1	..	..	..	1	10
40 Years..........	..	..	..	..	..	1	..	..	..	1	
42 Years..........	..	..	..	..	..	1	..	..	..	1	
43 Years..........	..	..	..	1	..	..	..	..	..	1	
49 Years....... ..	..	..	..	..	..	..	1	..	..	1	
60 Years..........	..	..	1	..	..	..	..	..	..	1	
Total............	125	166	130	152	94	46	24	14	18	769	58

of a valuable nucleus of workers, around whom a full staff could be readily built up at any time from among the large number of applicants for jobs. At the same time, they recommended that all young or inexperienced employees, commencing with those who had no dependents, be dismissed at once, and that further cuts be made in the staff if this procedure did not produce large enough economies. It was the opinion of these members of the personnel department that the salaries paid by the Digby National Bank should not be compared with those at which new employees could be secured, since the latter did not take into consideration faithful

performance for the bank, which should be rewarded regardless of the degree of mechanical skill displayed by a worker.

Should the Digby National Bank have reduced the number of its employees in the fall of 1930, in order to effect substantial economies? Should it have cut salaries?

If the adoption of the former course is assumed, what relative weight should be given to present salary and length of service in deciding which employees to retain, and which to discharge? What other factors should be considered?

Comment upon the rapidity of salary increases in relation to length of service in a commercial bank, as reflected in Exhibit 2.

27. AUDITING

DUNLOP NATIONAL BANK

THE AUDITING DEPARTMENT AND ITS RELATION TO THE CREDIT AND DISCOUNT DEPARTMENTS[1]

The auditing department of the Dunlop National Bank, one of the largest banks in Boston, performed the following duties: (*a*) verifying all assets and liabilities, (*b*) investigating procedure and methods followed in each department, and (*c*) checking the soundness of loans and investments. These duties were carried out by means of five types of internal audits, which were as listed in Exhibit 1.

EXHIBIT 1

Types of Internal Audits Used

I. Cash Verifications (at least four times a year).
II. Securities Verifications (at least twice a year).
   A. Bank's own securities. Collateral, custody accounts, etc., confirmed at time of general audit, or by a special audit.
III. General Audits (periodically).
   A. Verification. Proof or test of all assets and liabilities, including examination of all subsidiary accounts and records, covering entire period since previous audit.
   B. Examination of condition as to the following:
      1. Soundness—Loans and investments.
      2. Safety—Condition of accounts and records and adequacy of protective measures.
      3. Procedure—Operating methods.
      4. Earnings.
      5. Growth.
      6. Service.
IV. Special Audits (as required by conditions in any department or account).
V. Directors' Examinations (annual).
   A. Performed on behalf of the examining committee of the board of directors.

Three different methods were used in conducting an audit: (*a*) verification of accounts by proof or test against actual documents or holdings, (*b*) confirmation with customers, and (*c*) substitution of auditing force for employees in a department. The

[1] Consult: Millet, J. I., *Bank Audits and Examinations*, especially Chs. VII and VIII; Young, B. E., *Bank Cost Control*, Chs. VI–XI; American Bankers Association, *Commercial Bank Management Booklet No. 12*, *Internal Bank Auditing Procedure;* Potts, J. E., *Bank Accounting and Audit Control.*

procedure used in an investigation of the discount and credit departments, which was made at the time of a general audit, is shown in detail in Exhibit 2. The procedure followed in other departments was similar to that outlined in Exhibit 2.

The Dunlop National Bank was the only Boston bank in which the auditing department furnished a complete check on the soundness of loans and discounts. Many local institutions instructed their auditors to report steady loans, large loans, charged-off loans, and loans remaining on the books after criticism by bank examiners. However, the Dunlop National Bank was unique in requiring its auditing staff to pass upon the accuracy of credit analyses and to furnish a complete classification of loans and discounts according to quality. When the credit department was audited, the file concerning every customer having an unsecured loan or line of credit was reviewed in the manner shown in Exhibit 3. Collateral loans were classified largely on the basis of the security pledged.

The executive officers of the bank had received a review of loans and discounts from the auditor at least annually for many years, and were thoroughly convinced of the value of this device.[1] In the first place, it insured completeness of credit information concerning every borrowing customer. Secondly, it enabled the bank to escape adverse criticism from national and clearing house examiners, since it brought out apparent weaknesses in many loans which, although fundamentally sound, presented aspects which were not entirely clear to the outside critic. Thirdly, it furnished, in convenient form, a relative rating of the bank's credit risks. Finally, it provided a check on loaning officers in that these officers knew that they must be prepared to defend the credits which they extended. It had been the experience of the bank that employees in the credit department sometimes failed to

[1] Many writers on bank auditing contend that the auditor should submit his reports and suggestions for improvement in methods to the board of directors. The reasoning behind this contention is that complete detachment of the auditing department from banking functions allows greater freedom of action and a more impartial point of view. It was the belief of the officials of the Dunlop National Bank, however, that it was desirable to lend as much authority as possible to worthy suggestions originating in the auditing department. There was a danger that the heads of operating departments, whose methods had been rightly criticized, might have enough influence with the board to outweigh the auditor's recommendations. On the other hand, if the auditor's reports were submitted to the president and executive vice presidents of the bank, this difficulty would be avoided and, at the same time, the advantages of not having the auditor report directly to operating officials whose work he was auditing would be preserved.

EXHIBIT 2

Procedure Followed in Auditing the Discount and Credit Departments

I. Inspection of notes and collateral agreements.

II. Inspection of actual collateral on file, and check against records.
- A. Proper substitutious of collateral.
- B. Proper endorsement of securities.
- C. Proper assignment of pass books, insurance policies, accounts receivable, etc.
- D. Proper drawing of warehouse and trust receipts, shipping documents, etc.
- E. Verification of title to mortgaged property.

III. Inspection of credit files.
- A. Adequacy of data.
- B. Accuracy of analysis.

IV. Classification of loans.
- A. Quality.
- B. Type (secured and unsecured, time and demand).
- C. Diversification of unsecured loans according to line of business.
- D. Eligibility.
- E. Gross yield.

V. Inspection of operations.
- A. Records kept.
- B. Reports made.
- C. Methods of keeping collateral.
- D. Observance of margin requirements.
- E. Adherence to banking law.

VI. Inspection of service.

EXHIBIT 3

Review of Unsecured Credits

I. Information to be obtained.
- A. Loaning officer's or branch manager's opinion of the risk.
  1. From the file.
  2. From personal interview, if necessary.
- B. Agency reports.
- C. Financial statement analysis.
  1. Comparison with prior years.
- D. Information from company's officers.
  1. From the file.
  2. From personal interview, if necessary.
- E. Checkings.
  1. Bank.
  2. Trade.
- F. Bank's own experience.
  1. Age of account, affiliations, etc.
  2. Balances, profitability, etc.

II. Recommendation based on information obtained.
- A. Amount of credit which should be extended.
- B. Form which borrowing should take.

III. Classification of loans, with reasons.
- A. Good.
- B. Slow.
- C. Doubtful.
- D. Loss.
- E. Special mention because of inadequate information or unusual features.

question certain aspects of a loan because they hesitated to give the appearance of criticizing a superior officer. However, it was possible for loaning officers and members of the auditing staff to exchange views on credit risks without restraint, and the senior officers of the bank were unanimous in their belief that such a periodic exchange was beneficial in that it kept them informed concerning every detail of a loan.

Comment upon the widespread view among banks that internal audits should be concerned only with verification and betterments in procedure and methods, leaving the investigation of soundness to clearing house and national or state examinations.

Should the auditor of the Dunlop National Bank have submitted his report on the condition of loans and discounts to the executive officers or to the board of directors?[1]

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[1] For the civil liability of directors in connection with a false published report of bank condition, see case of Thomas v. Taylor, Ebersole, J. F., *op. cit.*, first edition, pp. 244-245.

28. EARNINGS AND DIVIDENDS

THE FARMERS AND MERCHANTS NATIONAL BANK[1]

DIVIDEND POLICY

The Farmers and Merchants National Bank of Cleburne, Texas, was organized May 26, 1890, with a capital of $100,000. In 37 years of operation it paid out $346,000 in dividends On May 11, 1927, a receiver was appointed by the Comptroller of the Currency, who listed as the apparent cause for the failure a local depression which had been unforeseen by the management. The liquidation of the bank was completed on September 10, 1928, when the remaining assets were purchased by another bank. The proceeds of the sale were used to make a final payment upon the claims against the bank. Less than 50% of the assessment against the stockholders was collected. The essential facts regarding the liquidation are summarized in Exhibit 1.

EXHIBIT 1

I. Approximate Results of Liquidation:—	
Book Value of Assets at Closing.	$720,091
Cash Collections from Assets, Plus Offsets Allowed and Settled (Exclusive of Collections from Assessment upon Stockholders)................................	409,375
Loss on Assets................................	$310,716
II. Approximate "Long Run" Earnings Record:—	
Dividends on Stock (Through Life of Bank)........	$346,000*
Loss on Assets at Liquidation (Not Including Receivership Expenses)..................................	310,716
Actual Earnings of Bank.........................	$ 35,284†

* 9.3% average per year on $100,000 for 37 years.
† .9% average per year on $100,000 for 37 years.

Could this bank have survived if it had not paid out its "profits" in dividends and had built up a larger surplus fund?

Should a bank invest its surplus fund in a different type of asset than its other funds?

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[1] *Annual Report of the Comptroller of the Currency*, 1931, pp. 433, 435, and 1927, p. 247.

BRETT NATIONAL BANK

DIVIDEND POLICY

The Brett National Bank was the second largest bank in a West Virginia city of 20,000 inhabitants. During 1930 and the first half of 1931, local trade had been adversely affected by the unsatisfactory conditions prevailing in agriculture and coal mining and by the general business depression. The bank had suffered substantial losses on its loans and discounts in the 18 months prior to June 30, 1931. Losses also had been taken in the bank's bond account, which was made up, for the most part, of second-grade securities. In December, 1930, bank examiners had required that $30,000 be charged off for depreciation in the value of investments, and a similar charge-off of $50,000 was ordered in June, 1931. The entire $80,000 was charged against undivided profits during the first six months of 1931.

Stock in the bank was held by more than 150 local residents. A dividend rate of 12% had been maintained on this stock for several years. Before 1930, the bank had earned this dividend by a substantial margin. However, the payments made in 1930 and the first six months of 1931 had come out of prior undivided profits, net losses after charge-offs having been sustained during each of the three half-yearly periods. Continuation of the regular dividend rate during this period had been opposed by certain of the bank's directors, but the majority of the board had favored these payments on the ground that a reduction or omission might destroy the confidence of the bank's depositors and result in a serious run. Several banks in the immediate vicinity of the Brett National Bank had failed between December 31, 1929, and June 30, 1931, and, although the bank itself had not suffered any appreciable decrease in deposits, the board of directors felt that it would be unwise to take any action which might be construed as a reflection upon the bank's strength.

Early in September, 1931, the board of directors met to consider the declaration of the semiannual dividend payable on September 30. During the two months which had elapsed since the publication of the June 30, 1931, statement, the market value of the

bank's bond portfolio had declined further and there had been no indication of revival in local trade or general business. The directors anticipated that additional charge-offs on both loans and discounts and investments would be ordered at the time of the second annual examination of the bank, which normally would take place in December. Bank failures in West Virginia were continuing unabated.

Statements of condition and income statements of the bank were as shown in Exhibits 1 and 2.

EXHIBIT 1

Statements of Condition of the Brett National Bank, as of December 31, 1929 and 1930, and June 30, 1931

	December 31, 1929	December 31, 1930	June 30, 1931
Resources			
Cash and Due from Banks	$ 572,083	$ 432,497	$ 289,130
Exchange and Collections, Net	5,191	7,246	7,521
Reserve with Federal Reserve Bank	190,473	152,707	151,874
United States Securities	247,680	250,080	314,880
Other Bonds and Securities	951,029	966,761	883,039
Loans and Discounts	1,948,767	1,626,373	1,549,324
Redemption Fund	9,500	9,500	9,500
Banking House	171,966	172,091	176,323
Total Resources	$4,096,689	$3,617,255	$3,381,591
Liabilities			
Demand Deposits	$2,385,264	$2,141,501	$2,166,303
Time Deposits	264,298	290,573	325,448
Circulation	190,000	190,000	190,000
Bills Payable and Rediscounts	367,822	182,400	....
Capital	300,000	300,000	300,000
Surplus	300,000	300,000	300,000
Undivided Profits	289,305	212,781	99,840
Total Liabilities	$4,096,689	$3,617,255	$3,381,591

What semiannual dividend should the bank have declared for payment on September 30, 1931?

Was the fact that operating income before losses and charge-offs covered dividend requirements in 1930 and the first half of 1931 sufficient justification for the payment of dividends during that period?

Assuming that the 6% semiannual dividend was declared, and the directors knew that additional substantial losses would have to be taken within a year, what further action, if any, should the directors have taken at the September, 1931, meeting?

EXHIBIT 2

Income Statements of the Brett National Bank for the Years Ending December 31, 1929 and 1930, and for Six Months Ending June 30, 1931

	December 31, 1929		December 31, 1930		June 30, 1931	
Interest Received on Loans and Investments	$195,589		$180,597		$78,600	
Exchange and Collection Charges	1,382		2,220		1,365	
Trust Department Income	4,233		2,400		502	
Other Income, Including Profits on Sale of Bonds	42,734		14,763		7,183	
Gross Income		$243,938		$199,980		$ 87,650
Interest Paid on Deposits	$ 19,255		$ 20,330		$11,710	
Interest Paid on Borrowed Money	14,599		12,027		1,937	
Salaries	65,998		67,985		34,368	
Other Expenses	29,791		31,375		13,608	
Taxes	21,619		27,389		480	
Total Expenses		151,262		159,106		62,103
Operating Income		$ 92,676		$ 40,874		$ 25,547
Losses on Loans and Discounts, Net of Recoveries	$ 1,378		$ 68,007		$40,403	
Losses on Bonds and Securities	19,767		12,400		80,047	
Other Charge-offs	272		991		38	
Total Net Losses and Charge-offs		21,417		81,398		120,488
Net Income after Losses		$ 71,259		$ 40,524(d)		$ 94,941(d)
Dividends Paid		36,000		36,000		18,000
Net Additions to Profits		$ 35,259		$ 76,524(d)		$112,941(d)

(d) Deficit.

CHIEF BANK AND TRUST COMPANY

SOURCES OF BANK EARNINGS[1]

The Chief Bank and Trust Company was a large state-chartered bank in an important industrial city on the Ohio River. By 1931 it had established a reputation as one of the better-managed banks in its district and had attracted many customers of all types. Large corporations, small businesses and individuals—all made use of the bank's services, which were made available at a main office and four branches within the city. The number of branches had grown to six in 1937. In addition to handling deposits subject to check, the bank had a small savings department and did a large trust business.

The statements of condition of the bank which appear in Exhibit 1 were prepared from published statements made available to depositors, stockholders, and the general public. They show the changes in the bank's earning assets, other assets, and liabilities, resulting from national and local events affecting banks in 1932 and 1939.

By 1932 the bank had experienced many of the results of the deflation which followed 1929. Loans and deposits had decreased, losses had been taken on investments, etc., and the bank was making new loans in smaller volume than it was making collections.

By 1939 general business conditions were much improved from the depths of depression. The demand for loans, however, was disappointingly low, and a large sum was of necessity invested in securities, largely government bonds, at low interest rates.

Changes in the items of income and expense are shown in Exhibit 2. The income statements for 1932 and 1939 are presented as they were prepared by the bank's auditor for the use of the management. In these statements the auditor has partially allocated costs to departments, etc., and all items of income and expense, except charge-offs, recoveries, and profits and losses on the sale of securities, have been presented. These latter items were not considered applicable to any calendar year, nor were they

[1] See *Federal Reserve Bulletin*, June, 1940, pp. 527–529, 588–601.

EXHIBIT 1

Statements of Condition of the Chief Bank and Trust Company as of December 31, 1932 and 1939*

	1932		1939	
	Amount	Per Cent	Amount	Per Cent
Assets				
Cash and Due from Banks	$ 7,496,694.00	13.91	$16,551,760.40	20.69
United States Bonds	4,583,956.50	8.51	27,832,697.68 (United States Bonds and Municipal Bonds)	34.80
Municipal Bonds†	764,570.70	1.42		
Other Bonds and Stocks	5,059,331.10	9.39	3,032,038.07	3.79
Demand Loans	23,978,415.60	44.50	15,417,555.94	19.27
Time Loans	8,357,977.80 (Time Loans and Real Estate Loans)	15.51	11,791,700.86	14.74
Real Estate Loans			1,276,072.65	1.59
Interest Accrued	‡		285,636.69	.35
Banking Houses§	3,420,477.90	6.35	3,315,707.30	4.27
Fixtures	none		none	
Other Real Estate	27,288.00	.06	238,259.48	.29
Customers' Liability on Letters of Credit	187,861.50	.35	170,017.25	.21
Total Resources	$53,876,573.10	100.00	$79,911,446.41	100.00
Liabilities				
Deposits	$48,306,026.70	89.65	$71,943,504.88	90.03
Bills Payable	none		none	
Reserves‖	1,073,722.50	2.00	1,496,824.48	1.87
Preferred Stock	none	none	1,800,000.00	2.25
Common Stock	1,800,000.00	3.34	2,520,000.00	3.16
Surplus	2,250,000.00	4.18	1,800,000.00	2.25
Undivided Profits	258,962.40	.48	181,099.80	.23
Liability on Letters of Credit	187,861.50	.35	170,017.25	.21
Total Liabilities	$53,876,573.10	100.00	$79,911,446.41	100.00
Trust Assets	$55,213,138.80		$91,954,300.17	

* Prepared from published statements.
† Principally obligations of the bank's own state and municipalities in that state.
‡ Included in the figures for loans.
§ After deduction of depreciation.
‖ Reserve for taxes, interest, and discount included in this item: 1932, $226,096.

treated as sources of income for dividends. The amounts of such charge-offs and recoveries from 1929 through 1939 are shown separately in Exhibit 3.

The following comments will serve to explain the material in Exhibit 2. The item "Small Loans" under "Interest Received" represents gross income from a department established during 1937. The department was experiencing rapid growth. The item "Small Loans" under "Reserves, etc." represents an

EXHIBIT 2

Statements of Earnings and Expenses of the Chief Bank and Trust Company for the Years Ending December 31, 1932 and 1939

	1932		1939	
	Amount	Per Cent	Amount	Per Cent
Earnings				
Interest Received				
Loans	$1,830,185.99	63.5	$ 935,631.64	35.4
Bonds, Stocks, and Mortgages	389,272.52	13.5	626,094.68	23.7
"Small Loans"	....	....	219,966.17	8.3
Bank Balances	13,550.85	.5	224.95	. . .
Total Interest Received	$2,233,009.36	77.5	$1,781,917.44	67.4
Fees and Other Charges Collected				
Trust Department	$ 86,609.99	3.2	$ 205,211.37	7.8
Foreign Department	11,838.03	.4	11,387.66	.4
Safe Deposit Department	20,341.56	.7	23,914.87	.9
Service Charges, All Departments	56,831.93	1.9	105,960.61	4.0
Commissions, etc.	43,081.23	1.5	37,490.44	1.4
Total Fees, etc.	$ 218,702.74	7.7	$ 383,964.95	14.5
Rents Received				
Bank Premises	$ 197,100.00	6.9	$ 217,854.00	8.3
Tenants, Main Building	201,387.38	7.1	193,376.60	7.3
"Other Real Estate"	617.41	.0	25,114.74	1.0
Electricity Sold Tenants	13,175.98	.5	21,649.85	.8
Other Services	8,110.81	.3	19,545.65	.7
Total Rents, etc.	$ 420,391.58	14.8	$ 477,540.84	18.1
Total Regular Earnings	$2,872,103.68	100.0	$2,643,423.23	100.0
Expenses				
Interest Paid				
Depositors	$1,109,068.90	46.8	$ 364,051.87	19.3
Borrowed Money	25,075.47	1.0		
Total Interest Paid	$1,134,144.37	47.8	$ 364,051.87	19.3
Expenses of Departments				
Auditing	$ 16,963.51	.7	$ 26,352.61	1.4
Bookkeeping	57,721.86	2.4	90,158.41	4.8
Collateral, Loans, and Credit	63,531.44	2.7	101,307.47	5.4
Foreign	8,593.62	.4	....	......
Investment	41,592.43	1.7	45,020.38	2.4
New Business	6,827.13	.3	15,642.70	.8
Officers (General)	113,588.47	4.7	154,029.71	8.2
Real Estate	....	.....	38,295.43	2.0
Safe Deposit	24,459.38	1.1	18,757.63	1.0
Savings	13,233.28	.6	8,351.90	.4
Small Loan	....	.....	111,087.57	5.9
Tellers	40,638.02	1.7	41,010.90	2.2
Transit	21,557.59	.9	24,034.61	1.3
Trust	74,946.92	3.2	111,964.70	5.9
General Banking	72,336.14	3.0	41,529.79	2.2
Overhead	193,271.10	8.1	144,985.87	7.7
Total Departments, Main Office	$ 749,260.89	31.5	$ 972,529.68	51.6
Departmental Expense, Branches	257,136.36	10.8	281,575.47	15.0
Total Expenses of Departments	$1,006,397.25	42.3	$1,254,105.15	66.6
Current Building Expenses				
Main Office	$ 194,724.59	8.2	$ 211,859.49	11.2
Branch Office	40,837.92	1.7	54,160.97	2.9
Total Current Building Expense	$ 235,562.51	9.9	$ 266,020.46	14.1
Total Regular Expenses	$2,376,104.13	100.0	$1,884,177.48	100.0
Reserves, etc.				
Amortization of Bonds	....		$ 62,793.32	
Depreciation of Buildings	$ 67,980.78		60,426.42	
Deposit Insurance Payments	....		53,856.00	
Small Loans	....		31,181.39	
Total Reserves, etc.	$ 67,980.78		$ 208,257.13	
Total Expenses and Reserves	$2,444,084.91		$2,092,434.61	
Distribution of Earnings				
Earnings before Dividends	$ 428,018.77		$ 550,988.62	
Dividends				
Preferred Stock	....		$ 77,999.99	
Common Stock	$ 202,500.00		204,750.00	
Total Dividends	$ 202,500.00		$ 282,749.99	
Earnings after Dividends	225,518.77		268,238.63	

EXHIBIT 3

Losses and Recoveries on Loans and Investments of the Chief Bank and Trust Company for the Years Ending December 31, 1929 to 1939
(Cents omitted)

Year	Losses Charged Off		Recoveries		Profits on Sales of Investments
	Investments	Loans	Investments	Loans	
1929	$130,374	$ 260,445	$ 23,484	$ 54,447	$105,255
1930	184,113	311,451	21,585	47,040	125,199
1931	357,882	560,592	28,050	49,818	151,026
1932	605,544	778,434	28,563	50,259	74,607
1933	709,671	694,260	154,545[*]	51,387	....
1934	725,367	1,137,882	280,740[*]	78,912	....
1935	410,229	564,711	469,935[*]	97,023	....
1936	280,017	464,892	193,644	192,246	472,848
1937	282,207	333,000	219,624	192,729	374,574
1938	309,027	198,609	88,146	116,304	229,860
1939	348,969	254,691	105,651	100,236	389,370

* Includes profits on sales of investments.

estimate of maximum future losses on small loans. At the end of 1939 there had been no important losses or continued delinquencies in the small loan department.

The item "Service Charges, All Departments" consists almost entirely of service charges on current checking accounts, while most of the item "Commissions, etc." represents fees for handling security transactions as intermediary between customers and brokers, and between the trust department and brokers.

The item "Bank Premises" under "Rents Received" represents the estimated fair rental value of the space used by the bank in the main office building which it owned. The upper floors of this building were rented to tenants.

The "Expenses of Departments" item represents the auditor's best estimate of the proper cost to be charged to each department. The bank employed between 300 and 400 men and women (of whom 31 were officers of the rank of assistant secretary or higher), most of whose salaries could be charged to a certain department. The salaries of the principal officers, however, were not allocated, because their duties did not relate to specific departments. The same situation held true in the case of office boys and others whose work could only be included under "General Banking."

While departments were charged for rent on the basis of the space occupied, many items of overhead were not allocated,

because any system of allocation would be based on arbitrary assumptions.

The items under "Reserves, etc." are of several types; "Amortization of Bonds" represents a reduction in the book values of bonds which were purchased at prices over par. The amount of amortization was scheduled for each bond held, so that the book value would be equal to or less than a call price when effective and equal to par at the maturity date. The item "Depreciation of buildings" is the usual type of annual charge. The amount of "Deposit Insurance Payments" is an estimated liability for the regular Federal Deposit Insurance premium, which is based upon average insured deposits. The item "Small Loans" has already been discussed.

The preferred stock of the bank was issued in 1934 and bore a dividend rate of 4%. Dividends on this stock had been paid regularly. Dividends on the common stock were suspended in 1933 and were not resumed until the third quarter of 1936, when an annual rate of 7½% of par value was instituted.

29. COST ANALYSIS OF CUSTOMERS' ACCOUNTS

WARREN NATIONAL BANK (A)

METHOD OF ANALYZING DEPOSITORS' CHECKING ACCOUNTS[1]

The Warren National Bank of Chicago, which on December 31, 1929, had total deposits of $138,200,400, and total loans, discounts, and investments of $147,194,700, had devoted a great deal of attention to the problem of analyzing depositors' checking accounts. Mr. Newton, the comptroller of the bank, had worked out a method of analysis which he believed to be sound, and which the Warren National Bank had used for a number of years. This method may be described concisely as follows:[2]

1. *Basic Charge for Number of Accounts.*—The number of checking accounts which a bank has is a known figure. For each account a bank must keep a name in its ledger, issue a monthly statement, and provide for the deposit and withdrawal of funds. Even though all accounts are extremely inactive, the very fact that they exist necessitates the employment of a bookkeeper, a teller, a statement clerk, and a proof clerk. This staff requires a certain amount of space in which to work and a certain amount of equipment. The cost involved in paying these employees and providing them with space and equipment is entirely independent of the activity of the accounts which they handle. Consequently, when this cost is computed and divided equally among the number of accounts on a bank's books, a basic expense figure is obtained. This figure should constitute a charge against each account, regardless of its activity. Accordingly, the Warren National Bank charges $4.20 per account per annum.

2. *Charges for Activity.*—The theoretical minimum of activity is greatly exceeded by almost every account. Consequently, a charge

[1] See: Sanders, T. H., "Cost Control in Banks," *Harvard Business Review*, July, 1928, pp. 420–432; Hetzel, F. W., *Analyzing Checking Accounts Scientifically;* Kniffin, W. H., Jr., *The Practical Work of a Bank*, eighth edition; American Bankers Association, *Commercial Bank Management Booklet No. 5, Does the Account Pay?*, *Commercial Bank Management Booklet No. 9, Practical Bank Analysis and Installation of Measured Service Charges*, and *Commercial Bank Management Booklet No. 15, Manual for Determining Per Item Costs.*

[2] It should be borne in mind that the following description is concerned only with the method and views of one institution, and is not to be considered more authoritative or more generally applicable than any other method.

must be made for the number of items which are put through each account. However, certain types of items are more expensive to handle than are other types, and allowance must be made for this fact.

When activity cost is interpreted in the strict and logical sense, it includes only those expenses which are directly traceable to the fact that depositors have put items through their accounts. These expenses consist of the salaries, rent, depreciation on equipment, supplies, postage, telephone, and other sundries which are chargeable to departments concerned with handling accounts. Such departments include: bookkeeping, tellers, coupon, collection, settlement, transit, and analysis.

It is possible, with a considerable degree of accuracy, to allocate such direct expenses to the several kinds of items handled. When the resulting classifications of expense are divided by the number of items in each classification, a close approximation to the actual cost per item of each type is secured. Each account can be charged according to the number and kind of items which are put through it. According to this method, the Warren National Bank makes the following charges (as explained more fully in Exhibit 1):

Item	Cost Each
Counter Checks	\$.0424
Clearing Checks	.0335
Returns	.2228
Deposit Tickets	.0439
Checks in Deposits	.0123
Collections	.2582
Coupons	.0298
Certified Checks	.1797
Checks (Printing, Etc.)	.0071

3. *No Charge for Expenses Which Cannot Be Allocated Definitely to Depositors' Accounts.*—When a cost is being computed for the handling of items put through depositors' accounts, it is purely arbitrary to include any part of the expenditures of a bank from which these accounts do not directly benefit.

When a bank is organized, the stockholders expect to furnish a building, capable management, promotion through advertising or otherwise, a guaranty fund to the depositors in the form of capital and surplus, and certain other necessities. They look to the expansion of the business, which is based largely on the funds of depositors, to return them a profit. Consequently, capital and surplus should be expected to earn at about the same rate as the rest of a bank's funds, and general expenses properly may be charged against the income therefrom. Specifically, it is not accurate to load depositors' accounts with costs which cannot be allocated definitely to them, and to ascribe all earnings to the funds provided by stockholders. If the business is conducted properly, there will be a profit from the handling of depositors' accounts, and full credit for this profit should be given where it is due.

EXHIBIT 1

Distribution of Direct Costs to Various Classes of Items

Average annual expenses directly attributable to the following departments, for the years 1923 to 1925: bookkeeping, tellers, coupon, collection, settlement, transit, and analysis

Salaries	$278,859
Rent	116,321
Supplies	75,408
Postage, Telephone, Etc.	26,772
Depreciation on Equipment	9,256
Miscellaneous	3,354
Total	$509,970

Of the foregoing expenses, careful estimates fixed $56,221 as the portion due to maintaining the minimum staff for customers' accommodation, which, divided by the number of accounts, 13,386, gave the basic charge of $4.20 per year each. This deduction left $453,749 for allocation according to activity.

Annual averages of total costs, number of each class of item handled, and resulting costs per item, for the years 1923 to 1925

Class of Item	Total Cost	Number	Cost Each
Counter Checks	$ 37,436	882,934	$.0424
Clearing Checks	197,541	5,896,735	.0335
Returns	1,133	5,084	.2228
Deposit Tickets	38,089	867,640	.0439
Checks in Deposits	78,959	6,419,414	.0123
Collections	35,360	136,947	.2582
Coupons	9,920	332,885	.0298
Certified Checks	6,903	38,414	.1797
Checks (Printing, Etc.)	48,408	6,818,083	.0071
Total	$453,749	21,398,136	.....

Expenses were allocated to the different classes of items, as follows:

1. The time spent by each department on each class of item was calculated. This was done by multiplying the number of items of each class handled by a department by the approximate time required for that department to put through such an item. An informal time study, conducted by department heads, insured a reasonable degree of accuracy in arriving at these approximate time weights.

2. The total expenses of each department were then divided on a time basis among the various classes of items handled.

3. The departmental costs for each class of item were then assembled and severally totaled by classes.

4. Total costs for each class of item were then divided by the number of such items which had been handled by the bank during a year. The resulting figures were the costs per item.

4. *No Charge for Loaning and Investing the Bank's Funds.*—The gross return from loans and investments should be reduced by an amount equal to the expense of making the loans and investments. It is not proper to charge those who provide a bank's funds with the

costs of employing such funds so that they will bring in a profit for the stockholders.

Mr. Newton felt that this method of analyzing depositors' accounts possessed the following advantages:

1. No depositor could claim that he was being rated unjustly when a claim of unprofitability was brought to his attention.
2. The allocation of administrative, investment, and other expense to depositors' accounts was arbitrary and, at best, depended to a large extent on estimates.
3. The analysis of accounts could not be mathematically exact. On the other hand, if it were made as accurate as possible, and if the depositor always were given the benefit of any doubt, the Warren National Bank could be certain that an account which showed a loss was actually unprofitable and would appear to be even more so by any other method of analysis. This made it possible to take definite action without any hesitancy as to accounts showing a loss.

The basic charge for number of accounts and the activity costs for the various types of items passing through the bank had been calculated by Mr. Newton from the Warren National Bank's expense figures for the years 1923, 1924, and 1925. Since that time, Mr. Newton had made an annual check of these charges, but variations from the figures originally set had been so slight that he had not considered it worth while to make any change.

Early in the spring of 1930 Mr. Ames came from a large New York institution to the comptroller's office of the Warren National Bank. After studying Mr. Newton's method of account analysis, Mr. Ames suggested that he believed it would be desirable to change the entire system. He based this conclusion on two major considerations:

1. Existing cost figures were too low and did not give a fair picture of the expenses actually chargeable to the handling of an account. This was due to the failure to distribute any part of administrative, investment, and other expense to depositors' accounts. These accounts should be so charged, since the expenses were necessary in order to operate an institution where funds might be safely and conveniently kept. Some inaccuracy in distributing these indirect expenses would be preferable to ignoring them altogether.
2. One of the most important reasons for analyzing accounts was to arrive at cost figures which could be compared with those of competitors. It was usually possible to obtain these figures from other banks, as well as an approximate description of the methods used. Thus, although exact operating figures could not be secured, it would be possible to work back and discover where the Warren National Bank was incurring larger expenses than were similar institutions.

EXHIBIT 2

Distribution of 1929 Costs for the Purpose of Analyzing Depositors' Accounts—Suggested Method A—Administrative, Investment, and Other Expense Entirely Distributed*

	Total	Item Cost	Investment Cost	Savings Department	Banking Overhead	General Overhead	Fiduciary and Other Activities	Charges Direct to Departments
Direct Expense								
Accounting, Bookkeeping, and Analysis	$ 284,183	$ 284,183						
Tellers and Collection								
Tellers	151,867	151,867						
Collection	26,945	26,945						
Transit Department	50,188	45,169		$ 5,019				
Other Items (Direct Stationery, Supplies, Etc.)	74,713	74,713						
Loan Department	102,402		$102,402					
Savings Department	60,738			60,738				
Other Expenses								
Bonds Securing Deposits	21,990							$ 21,990
Credit Department	81,473		81,473					
Check Books	4,308	4,308						
Sundries	5,716				$ 5,716			
Officers' Salaries—Banking	143,800	28,760	71,900	14,380	28,760			
Fiduciary and Other Activities	266,498						$266,498	
Total—Direct Expense	$1,274,821	$ 615,945	$255,775	$ 80,137	$ 34,476		$266,498	$ 21,990
Overhead or Indirect Expense								
Officers' Salaries—General	390,450					$390,450		
Other Salaries—General	53,864					53,864		
Stationery and Supplies	77,909					77,909		
Postage	69,816	36,305	2,793	1,396	1,396	22,341	5,585	
Telephone and Telegraph	51,128					51,128		
Fees and Examinations	61,840					61,840		
Insurance and Fidelity Bonds	90,376					90,376		
Rent	300,182	108,066	108,066	12,007	42,025		30,018	
General Expenses	117,685					117,685		
Depreciation on Equipment	53,016	26,508	5,301	2,651	7,954	5,301	5,301	
Repairs and Replacement of Equipment	24,252	12,126	2,425	1,212	3,639	2,425	2,425	
Expenses of Securing Business	79,393							79,393
Total—Direct and Indirect Expense	$2,644,732	$ 798,950	$374,360	$ 97,403	$ 89,490	$873,319	$309,827	$101,383

Nonproductive Expense								
Pensions	19,814	....	....	....	....	19,814	....	....
Miscellaneous Donations	22,625	....	....	....	....	22,625	....	....
Other Items	75,342	....	....	....	....	75,342	....	....
Group Insurance	30,912	15,456	3,091	1,546	1,546	6,182	3,091	....
Total Expense	$2,793,425	$ 814,406	$377,451	$ 98,949	$91,036	$997,282	$312,918	$101,383
Distribution of Banking Overhead†	....	57,353	27,311	6,372	91,036§	....	....	....
Distribution of General Overhead‡	....	518,587	249,320	59,837	....	997,282§	169,538	....
Total Expense—Reallocated	$2,793,425	$1,390,346	$654,082	$165,158	....	....	$482,456	$101,383
Deduct, for Number, 15,437 Accounts at $3‖	....	46,311	....	....	....	....	....	....
26,573,672 Items, or $.05058 per Item	....	$1,344,035	....	....	....	....	....	....
Average Earning Funds $122,152,000, or $5.35 per $1,000	....	....	$654,082	....	....	....	....	....

* Adapted from New York State Bankers' Association, *Report of Committee on Bank Costs.*

† To Item Cost 63%
  Investment Cost 30%
  Savings Department 7%

‡ To Item Cost 52%
  Investment Cost 25%
  Savings Department 6%
  Fiduciary and Others 17%

§ Credits.

‖ Arbitrary figure.

EXHIBIT 3

Distribution of 1929 Costs for the Purpose of Analyzing Depositors' Accounts—Suggested Method B—Administrative, Investment, and Other Expense Partially Distributed*

Distribution of Total Operating Expenses

	Total Expense	To Capital, Surplus, and Loans	To Other Departments	To Depositors' Accounts	
Officers' Salaries	$ 534,250	60%	10%	30%	$ 160,275
Employees' Salaries	966,398	10	10	80	773,118
Rent, Taxes, Insurance, and Depreciation on Real Estate	397,812	18	25	57	226,753
Other Taxes	149,366	100	....	....	....
Other Insurance	120,288	75	12½	12½	15,036
Stationery, Printing, Supplies	142,697	16½	16½	67	95,607
Telephone and Telegraph	76,813	16½	16½	67	51,465
Postage and Express	54,056	16½	16½	67	36,218
Publicity	102,377	50	17	33	33,784
Miscellaneous	249,368	40	20	40	99,747
	$2,793,425	....	....		$1,492,003

Subdivision of Operating Expenses Allocated to Depositors' Accounts

	For Activity		For Size		For Number	
Officers' Salaries	33⅓%	$ 53,425	33⅓%	$ 53,425	33⅓%	$ 53,425
Employees' Salaries	50	386,559	17	131,430	33	255,129
Rent, Taxes, Insurance, and Depreciation on Real Estate	75	170,065	....	....	25	56,688
Other Taxes	....	....	....	....	....	.....
Other Insurance	50	7,518	25	3,759	25	3,759
Stationery, Printing, Supplies	67	64,057	....	....	33	31,550
Telephone and Telegraph	67	34,482	....	....	33	16,983
Postage and Express	75	27,164	....	....	25	9,054
Publicity	50	16,892	....	....	50	16,892
Miscellaneous	67	66,830	....	....	33	32,917
		$826,992		$188,614		$476,397
26,573,672 Items at $.03112		826,992	....	....	....	....
Average Deposits $139,761,000, or $1.35 per $1,000	....	....		188,614	....	....
15,437 Accounts at $30.86	....	....	....	....		476,397

* Adapted from Federal Reserve Bank of New York, *Analysis of Depositors' Accounts—Short Method*, revised edition, July, 1920.

However, the majority of Chicago banks included at least some part of administrative, investment, and other expense in their cost figures, and calculated their activity costs on the basis of a flat charge for all items, regardless of their character. Consequently, it would be well for the Warren National Bank to adopt such a system for purposes of comparison.

Using the expense figures of the Warren National Bank for the year 1929, Mr. Ames worked out two methods of account analysis, which are shown in Exhibits 2 and 3. The first method undertook to absorb practically all administrative, investment, and other expense into direct costs. The second charged a portion of these expenses into direct costs and allocated the

EXHIBIT 4

Results of Analyzing the Account of J. R. Holden, Incorporated, by Three Different Methods*

Gross Income

	September, 1930	October, 1930
Average Ledger Balance..........	$72,700.00	$82,000.00
Average Uncollected Balance......	43,300.00	45,200.00
Net Collected Balance..........	$29,400.00	$36,800.00
Less Reserve (Including Till Money)	4,410.00	5,520.00
Net Earning Funds..............	$24,990.00	$31,280.00
Earnings Rate—4%†	83.30	104.25
Service Charge................	....	....
Interest Paid—1½% of Collected Balance......................	36.75	46.00
Gross Profit....................	$46.55	$58.25

Cost

I. By Warren National Bank's Present Method

Items	Number	Amount	Number	Amount
Clearing Checks at $.0335.........	518	$17.35	602	$20.17
Deposit Tickets at $.0439....	139	6.10	151	6.63
Checks in Deposits at $.0123......	1,524	18.75	1,692	20.81
Certified Checks at $.1797..	.....	......	8	1.44
Checks (Printing, Etc.) at $.0071 ..	518	3.68	610	4.33
Total Activity Cost....	.....	$45.88	.....	$53.38
Basic Charge (at $4.20 per Annum)	.....	.35	.....	.35
Gross Cost.....................	.....	$46.23	.....	$53.73
Net Profit......................	.....	.32	.....	4.52

II. By Suggested Method A—Administrative, Investment, and Other Expense Entirely Distributed

	Number	Amount	Number	Amount
Number of Items at $.05058.......	2,181	$110.31	2,453	$124.07
Charge for Number of Accounts (at $3 per Annum)................	.....	.25	.....	.25
Investment Cost (at $5.35 per $1,000 of Loanable Funds per Annum)..	.....	11.14	.....	13.95
Gross Cost......................	.....	$121.70	.....	$138.27
Net Loss........................	.....	75.15	.....	80.02

EXHIBIT 4. (*Continued*)

III. By Suggested Method B—Administrative, Investment, and Other Expense Partially Distributed

	Number	Amount	Number	Amount
Number of Items at $.03112...... ..	2,181	$67.87	2,453	$76.34
Charge for Number of Accounts (at $30.86 per Annum)............	.....	2.57	.....	2.57
Charge for Size of Accounts (at $1.35 per $1,000 of Net Balance per Annum)..................	.....	3.31	.....	4.14
Gross Cost......................	.....	$73.75	.....	$83.05
Net Loss........................	.....	27.20	.....	24.80

* See case of Warren National Bank (B), *infra*.
† The Warren National Bank varied the effective rate of return on its earning funds from time to time according to money market conditions. The rate used was always an approximate rather than an exact one, and the bank consciously used a somewhat liberal figure in accordance with its policy of giving depositors' accounts the benefit of every doubt when analyzing them for profitability.

remainder against income from capital and surplus and against the income derived from the employment of depositors' funds in making loans and investments. Mr. Ames then compared the results obtained by analyzing the same account by the method then in use and by his two suggested methods (see Exhibit 4).

What are the relative advantages and disadvantages of each of the three methods of distributing costs? Which method should have been adopted by the Warren National Bank?

Are the relationships between the number of accounts, the number of items handled, and the total of deposits of the Warren National Bank typical for any commercial bank? To what extent should variations from the typical in the nature of the accounts handled influence the selection of a method for allocating expense among the number of accounts, the number of items handled, and the size of the balances maintained?

Is it probable that this phase of cost accounting ever will attain a high degree of exactness in any commercial bank? If so, can it be brought to such a point at a cost commensurate with its value to the bank? If not, what justification is there for dropping an account when analysis shows it to be unprofitable?

Should the rate credited upon net earning funds (Exhibit 4) include full allowance for total costs incurred in making loans and investments?

WARREN NATIONAL BANK (B)

ACTION TO BE TAKEN ON A DEPOSIT ACCOUNT OF DOUBTFUL PROFITABLENESS

During November, 1930, the Warren National Bank of Chicago analyzed the account of J. R. Holden, Incorporated (see Exhibit 1). This company, which was a manufacturer and wholesaler of folding boxes, cartons, foil wrappings, and labels, had been a customer of the bank for a number of years, and its deposit account never had been a particularly profitable one. A large part of the company's business was transacted with drug and confectionery stores and small manufacturing companies, payments being received frequently and in small amounts, so that deposit tickets, each one of which covered a large number of checks, came in daily. Furthermore, the collection of these checks, many of which were on points at a considerable distance from Chicago, took time and created a large float of uncollected items. The company was in the habit of drawing an average of nearly 20 checks a day in payment for materials and to care for the payroll of its office force. The Warren National Bank also incurred some expense in preparing the cash with which the company paid its factory workers each week, but never had made any charge for this service.

J. R. Holden, Incorporated, had an unsecured line of credit, amounting to $200,000, at the Warren National Bank. The company was neither a heavy nor a continuous borrower, loans having been outstanding during only six of the first ten months of 1930, and having averaged $70,000 in those months. At the time the deposit account was analyzed, J. R. Holden, Incorporated, was paying 5% on borrowings, the rate having been reduced from 5½% on July 1, 1930. There never had been any question as to the soundness of the loan.

The Warren National Bank knew that the Magnolia Dairies, a large middle-western distributor of milk, eggs, butter, cheese, ice cream, and allied products, held a substantial block of J. R. Holden, Incorporated, stock and gave the latter concern a good deal of business. The Magnolia Dairies had a rather active account at the Warren National Bank. Repeated efforts had

failed to induce the company to carry a ledger balance of more than $50,000, and it never had borrowed from the bank. It was known that the Magnolia Dairies intended to expand its operations in the Chicago territory.

Mr. Paul Holden, the president of J. R. Holden, Incorporated, was a wealthy man. He did not have a personal account at the Warren National Bank, but was being solicited by a representative of the trust department; his trust business, if secured, promised to be profitable for the bank.

J. R. Holden, Incorporated, had a borrowing account also at the Willow Park Trust Company, a suburban bank where it had secured its first line of credit. Officers of the Warren National Bank knew that the company carried a ledger balance of approxi-

EXHIBIT 1

Special Recapitulation of Profit Sheet for Account of J. R. Holden, Incorporated*

Name J. R. Holden, Incorporated		Interest Terms 1½%	
Average Ledger Balance Past Year	$81,300	Net High Month Past Year	$58,000
Average Uncollected Balance Past Year	37,500	Net Low Month Past Year	29,400
Average Net Balance Past Year	43,800		

	September	October
Gross Income	$83.30	$104.25
Less Interest	36.75	46.00
Gross Profit	$46.55	$ 58.25
Less Activity Cost	46.23	53.73
Net Profit	$ .32	$ 4.52
Expected Return—1% of Net Earning Funds	20.83	26.07
Excess above 1%	......	......
Deficiency below 1%	20.51	21.55

Contracts, Affiliations, Remarks

Magnolia Dairies holds a large minority interest in J. R. Holden, Incorporated.

The company has an account with the Willow Park Trust Company, where it carries a ledger balance larger than the one it gives us.

Mr. Holden is being solicited by our trust department and is a good prospect.

McCaskey, the company's treasurer, is not an easy man with whom to deal.

Date of Analysis November 18, 1930.

* For further details regarding this account, see the case of Warren National Bank (A), Exhibit 4, *supra*.

mately $100,000 at the trust company, and that its account there was not a particularly active one.

As shown in Exhibit 1, the account of J. R. Holden, Incorporated, at the Warren National Bank did not appear to be actually unprofitable. However, the bank felt that it was entitled to a profit of 1% per annum on the net earning funds provided by each deposit account. This profit was not being realized.

Should the Warren National Bank have requested J. R. Holden, Incorporated, to remove its deposit account? If not, what policy should the bank have adopted?

What difference, if any, should there have been in the bank's action on this account if it had been analyzed by Method A, suggested in the case of the Warren National Bank (A)[1]? If it had been analyzed by Method B, suggested in the same case?

Is the expectancy of a "profit" equal to 1% of the earning funds contributed by each account based on an allocation of overhead expense?

If all banks used the same method of cost analysis of depositors' accounts and insisted upon the removal of all accounts not showing a profit, what would result?

[1] *Supra.*

30. PUBLIC RELATIONS

THOMAS BANK

PUBLIC OPINION AND CUSTOMER RELATIONS[1]

On its receipt by the Thomas Bank in March, 1940, a copy of Bulletin 79 of the American Bankers Association, entitled "Survey of Public Banking Hours," was circulated among the directors. When it was proposed at a board meeting in April that the Thomas Bank close on Saturdays, Mr. Oliver, one of the directors, immediately opposed any action without first canvassing the probable effects of such a step upon customer opinion.

Banking policies, he said, were reflected in the attitude of depositors, other customers, employees, and the public toward the banks. The suggested policy was one that might easily create an unfavorable reaction. To find out what people thought about the Thomas Bank or its policies was not a simple task, he continued. In his own case, the only criticism he had heard of the bank had come from his wife, who had at times objected to service charges on her deposits and to occasional curt treatment by a teller. Earlier experience had taught him the importance of courtesy and tact in the loan officers' relations with customers. Such personal evidence was fragmentary and not reliable as an indication of public opinion. He urged that the problem deserved attention as a major policy, rather than as an isolated decision regarding closing on Saturday.

As a result of the discussion on the subject, the board decided to make a thorough investigation of the many factors which might influence public opinion. Several members scanned the available literature but found it limited in quantity. Others agreed to study the points of contact between the bank and the public to ascertain whether impressions given were favorable or unfavorable.

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[1] See: Jones and Church, *At the Bar of Public Opinion;* Batchelor, Bronson, *Profitable Public Relations;* Ilg, R. A., *Public Relations for Banks;* American Bankers Association, *Public Relations for Banks,* Studies Nos. 1–4; National Industrial Conference Board, Inc., *A Statistical Survey of Public Opinion,* Study No. 205, p. 28, and Study No. 222, pp. 33–35, 46; *Fortune,* January, 1936, p. 144, and August, 1938, p. 72.

Mr. Oliver believed that public opinion was the reflection of the attitude of those who had direct dealings with the banks. He therefore talked to those men in the Thomas Bank who were in continual contact with customers. From Mr. Burgess, who was in charge of new business, he learned of several incidents which he thought highly significant. In the search for new loans, Mr. Burgess made a practice of calling on companies with a bond or preferred stock issue which could be refunded at much lower cost with a term loan from a bank. Now and then, he told Mr. Oliver, his suggestion for financing through the bank at a lower rate had been rejected without apparent consideration. In a few of these instances, the executives called upon had admitted that the cost of capital would be less if obtained from the bank but asserted that they were glad to pay the difference just to be free of the banks. For illustration, Mr. Burgess exhibited an entry on one of his file cards describing a call: "Said he never would forget 1921, when the banks 'pounced' on him. 'I had my experience with you fellows then; you'll never get me in debt to the banks again.'"[1]

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[1] For a discussion of the obligation of banks to meet the needs of their customers and not to discriminate between them when circumstances are equal, see Neiswanger, W. A., "Banking, A Public Utility Analogy," *Wisconsin Law Review*, VI (April, 1931), pp. 131–143.

VII

COOPERATIVE CONTROL AND PUBLIC SUPERVISION

31. CLEARING HOUSES

POTTER TRUST COMPANY

ADVISABILITY OF JOINING A CLEARING HOUSE ASSOCIATION[1]

The Potter Trust Company, one of the newer and smaller downtown banks in a large middle western city, had capital and surplus of $3,000,000, and total deposits of $22,000,000, on December 31, 1930. Although the Potter Trust Company had a moderate number of small commercial accounts, approximately one-half of its deposits consisted of savings accounts, and in recent years the growth of the institution had been almost entirely in the savings department. The directors and officers of the bank were anxious to increase the importance of the commercial end of the business, but the larger size and longer-established reputation of several other banks in the financial district had made it difficult to secure any considerable volume of demand deposits.

The Potter Trust Company never had been a member of the clearing house association of the city in which it was located. In January, 1931, however, Mr. Hamlin, the president of the bank, recommended to the board of directors that they consider the advisability of joining the association.[2] Mr. Hamlin stated that in difficult times, such as had been besetting banks throughout 1930, clearing house membership was reassuring to depositors, while a certain amount of suspicion was apt to surround banks which did not hold such membership. He cited also the excellent record of metropolitan clearing house associations in supporting and protecting their members, and the salutary influence of rigid clearing house examination.[3]

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[1] References: American Bankers Association, *Commercial Bank Management, Regional Clearinghouse Associations*, and *City Clearinghouse Associations*.

[2] Application for membership in a clearing house association does not assure an election. For example: "When Mr. George F. Baker first came to New York, the refusal of the New York Clearing House Association to recognize the First National Bank was one of the great difficulties of his baby institution. His bank cleared through the Bank of the Republic, which many years after was absorbed by the First National . . . the opposition was finally withdrawn." *Commercial and Financial Chronicle*, January 17, 1925, p. 275.

[3] The National City Bank of New York, *Economic Conditions, Governmental Finance, United States Securities*, January, 1931, pp. 5–7.

Certain of the directors of the bank were opposed to joining the clearing house, on the following grounds:

1. The various restrictions imposed by the association, as shown in Exhibit 1, limited the freedom of action of members to an unwarranted extent.

2. Admission to the clearing house, which depended on recommendation by the clearing house committee based on a thorough examination of the applying bank and on the affirmative vote of two-thirds of the members, involved a fee of $200. After being admitted, each member bank had to meet its *pro rata* share of the running expenses of the association and of any losses suffered during the distribution of clearing checks by the clearing house. In addition, members were subject to a schedule of fines, varying from $10 for nonattendance at meetings to $1,000 for infraction of the association's rules (see Exhibit 1, numbers 3, 4, 5, 6, and 7).

3. Since the Potter Trust Company was a member of the Federal Reserve System and was located in a reserve city, clearing house membership was unnecessary so far as the handling of checks was concerned.[1]

EXHIBIT 1

Clearing House Association Rules Which Limit the Freedom of Action of the Participating Banks*

1. Inspection.—The [Clearing House] Committee shall establish a Department of Examination and appoint an Examiner in charge thereof, who shall keep informed as to the condition of every member and associate member . . . and have power to inspect all the books, papers, and property of the members and associate members and to make such examinations of their affairs and proceedings as he may see fit or the Committee may desire.

2. Reports.—Every member and associate member shall submit weekly information on such subjects and in such form and manner as the Clearing House Committee may prescribe.

3. Restriction of Interest Rates Which May Be Paid.—Subject to the action of the Clearing House Committee . . . no member of this Association shall agree to pay, or shall pay, directly or indirectly, on any net and available credit balance or on any certificate of deposit issued by such member, interest at an annual rate in excess of the rates indicated in the schedule below:

Schedule of Maximum Interest Rates Which May Be Paid

Demand Deposits.—On Certificates of Deposit payable within thirty days from demand; on Credit Balances payable on demand; and on Credit Balances payable within thirty days from demand.

* Quoted from the constitution and regulations of the clearing house association in the city where the Potter Trust Company was located.

[1] See Regulation J of the Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, September, 1939, pp. 720–721. As of the date of this case, see Regulations of the Federal Reserve Board, Regulation J, *Annual Report of the Federal Reserve Board*, 1930, pp. 260–263.

EXHIBIT 1. (*Continued*)

To Banks

When the Local Federal Reserve Bank Ninety-Day Discount Rate for Commercial Paper Is*	To Banks, Trust Companies, and Private Bankers	To Savings Banks, Building and Loan Associations, Etc.
Less than 2½%	1%	1½%
2½% or Over, but Less than 3 %	1¼	1¾
3 or Over, but Less than 3½	1½	2
3½ or Over, but Less than 4	1¾	2¼
4 or Over, but Less than 4½	2	2½
4½ or Over, but Less than 5	2¼	2¾
5 or Over	2¼	3

To Corporations, Firms, Individuals, Etc.

When the Local Federal Reserve Bank Ninety-Day Discount Rate for Commercial Paper Is*	To Others, Including Balances to Credit of Banks or Trust Companies When Specifically Designated as Trust or Agency Accounts
Less than 2½%	1¼%
2½% or Over, but Less than 3 %	1½
3 or Over, but Less than 3½	1¾
3½ or Over, but Less than 4	2
4 or Over, but Less than 4½	2
4½ or Over, but Less than 5	2½
5 or Over	3

Time Deposits.—On certificates of deposit payable on or after thirty days from the date of issue or demand, and on credit balances payable on or after thirty days from demand.

When the Local Federal Reserve Bank Ninety-Day Discount Rate for Commercial Paper Is*	All Time Deposits
Less than 2½%	1¾%
2½% or Over, but Less than 3 %	2
3 or Over, but Less than 3½	2¼
3½ or Over, but Less than 4	2½
4 or Over, but Less than 4½	3
4½ or Over, but Less than 5	3¼
5 or Over	4

The above schedule of maximum interest rates to be paid on time certificates or time deposits does not apply to such certificates or deposits payable more than six months from the date of issue or demand.

* The interest which members may pay on deposits does not vary automatically with the rediscount rate. The constitution and regulations of the clearing house association provide that, "It shall be the duty of the Clearing House Committee to hold a meeting . . . after notice of any change in said discount rate . . . to determine if said interest rates should be changed in accordance with the schedule, or if any other change should be made therein."

EXHIBIT 1. (*Continued*)

4. Free Balances.—In the calculation of interest allowed upon every deposit account subject to check and payable on demand, the average collected balance of which is less than $10,000 . . . there shall be deducted from the aggregate daily balances for the month an amount of $500 for each day, as a portion of such account free from the payment of interest by the member bank.

5. Service Charge.—Every deposit account subject to check and payable upon demand . . . the average monthly collected balance of which is less than $300 in any month, shall be charged not less than $1, as compensation for services rendered by the member bank in handling the account during such month. Any account against which no checks are drawn during the month shall be exempt from the charge.

6. Charges for Acting in Behalf of Other Banks.—Every member of this Association acting for a National Bank, Savings Bank, or Trust Company in making any loan secured . . . by stocks and/or bonds . . . shall charge and collect for so doing not less than ½ of 1% per annum of the amount of such loan during the period it shall remain in force.

Every member of this Association acting as custodian for collateral to loans made by banks, savings banks, or trust companies . . . shall charge for such service at a rate not less than 2% of the amount received by the lender for interest or discount upon such loans.

7. Collection Charges.—For all items payable within the Federal reserve district, excepting those which are made discretionary* . . . the collecting bank shall charge not less than 1/10 of 1% of the amount of the items, respectively, and in no case less than 10 cents upon any one item, but it shall not be obligatory to charge more than $5 upon any one item. For the purpose of fixing the amount to be charged, items having the same payer and the same maturity, received from any one depositor or correspondent on the same day, may be added and treated as one item.

For all items received, except those declared discretionary . . . payable at points outside the Federal reserve district, the collecting bank shall charge not less than 1/10 of 1% of the amount of the items respectively, and in no case less than 15 cents upon one item, but all checks described in this section, received from any one depositor or correspondent on the same day, may be added together and treated as one item for the purpose of fixing the amount to be charged.

In computing interest on chargeable items received for deposit, no collecting bank shall give credit for such items on terms more favorable than would have been the case if such items could have been collected through the local Federal reserve bank.

* Certain items, such as those collected for the Federal and state governments, those drawn on banks designated by the Federal Reserve Board in its list of institutions on which collection at par will be made, those payable within the Federal reserve district which may be collected through the local Federal reserve bank at par, those received from outside the United States and Canada, etc., need not be charged for unless a member sees fit to do so.

On what grounds, if any, might the directors of the Potter Trust Company object to clearing house examinations, inasmuch as the bank was subject to state examinations? Compare clearing house examinations and others as to quality and results.

Are there any important objections to the making of a weekly report to the clearing house?

Should one expect a bank which derives most of its deposits from large corporations keeping balances payable on demand to adopt a different attitude toward the restrictions on the amount of

interest which clearing house members may pay on deposits from that of a bank of the type of the Potter Trust Company?

What is the purpose of the $500 deduction from daily balances which the clearing house requires before the calculation of interest on deposits?

How can the clearing house management justify the required service charge when it would result in the loss of many small, but relatively inactive, checking accounts to suburban banks which do not have such strict requirements?

Would the making of stock exchange loans and the acting as custodian for collateral, free of charge, be of great value to a metropolitan bank in securing and holding the accounts of out-of-town correspondents?

Is it probable that the schedules of collection charges imposed by the clearing house have worked to the disadvantage of members in securing business from those concerns depositing large numbers of out-of-town checks?

Precisely what responsibility does a clearing house assume for the maintenance of the solvency of its members?

For what reasons, if any, should the Potter Trust Company have applied for membership in the clearing house association in January, 1931? Are any reasons evident why the application of this bank might be denied?

FORT DEARBORN BANKS

CLEARING HOUSE ACTION IN THE CASE OF A MEMBER IN DIFFICULTY

In December, 1921, the examining staff maintained by the Chicago Clearing House Association returned distinctly unfavorable reports on the condition of the Fort Dearborn National Bank and the Fort Dearborn Trust and Savings Bank. These institutions were among the important banks in Chicago at that time, and were members of the clearing house association. For several days subsequent to the receipt of these reports, the clearing house committee gave careful consideration to the possibility of the failure of the Fort Dearborn banks, the effect which such a failure would have on other banks in the city, and the measures which might be taken to avert it. The committee concluded that the closing of the Fort Dearborn banks would shake public confidence to such an extent that serious runs might result elsewhere. In order to prevent such a development, it appeared desirable that the Fort Dearborn banks be taken over by some larger and stronger institution.

On Thursday, December 29, W. A. Tilden, president of the Fort Dearborn banks, called upon James B. Forgan, chairman of the board of the First National Bank, requesting that the First National Bank and the First Trust and Savings Bank take over the Fort Dearborn banks. The First National Bank of Chicago agreed to make an examination of the affairs of the embarrassed institutions and to determine, on the basis of this examination, whether and under what conditions it would be willing to assume their liabilities.

At that time the Fort Dearborn National Bank had capital of $5,000,000, surplus of $2,000,000, and undivided profits of approximately $1,115,000. On the September 6, 1921, call date it had reported deposits of $51,124,749 and total resources of $75,169,070. The Fort Dearborn Trust and Savings Bank, in its December 31, 1921, report to the Illinois auditor of public accounts, showed capital of $500,000, surplus of $500,000, undivided profits of $273,868, time deposits of $8,009,470, demand

deposits of $1,807,851, and total resources of $11,689,579. The *New York Times* of January 3, 1922, said: "The difficulties of the Fort Dearborn banks are attributed to overextension by Edward Tilden & Company (the Tilden estate), who are the chief stockholders in the banks, and to some recent bad loans by the banks. The institutions, it is said, instead of confining themselves to banking, went into financing. They spread out into manufacturing, merchandising, and real estate. The business depression froze up some of the loans, while some depreciated in value." The same paper stated that losses of the Fort Dearborn National Bank "are estimated to be so large as to wipe out the surplus and undivided profits and impair the capital by about $1,000,000. In addition, it is estimated that the bank has about $15,000,000 of slow assets." In regard to the Fort Dearborn Trust and Savings Bank, the paper said, "It is estimated that the losses will more than wipe out the capital, the surplus, and the undivided profits."

At a meeting of the clearing house committee held on Monday, January 2, 1922, the First National Bank offered to purchase the Fort Dearborn banks and presented a tentative plan as a basis on which it would take over their business. At this time the Continental and Commercial National Bank and its affiliate, the Continental and Commercial Trust and Savings Bank, asked permission to submit a bid. When the two proposals were compared, the Continental and Commercial National Bank's bid was found to be the more liberal. Therefore, it was decided to accept the terms of the Continental and Commercial banks for the business and all the assets of the Fort Dearborn banks except the bank building, which had been sold to the First National Bank some time before.

During the night of January 2, the assets, books, and fixtures of the Fort Dearborn banks were removed to the Continental and Commercial National Bank building, and on Tuesday, January 3, the personnel of the Fort Dearborn banks took up its duties in the new quarters.

On the morning of January 3, the following statement by James B. Forgan, chairman of the Chicago Clearing House Committee, appeared in the newspapers:

Owing to the overextended condition of Edward Tilden & Company and some recently-made loans and investments which proved to be bad and entailed heavy losses, it was found on examination of the two

Fort Dearborn banks by the Chicago Clearing House examiner that the capital of both banks had been impaired.

It was realized that under these circumstances it was necessary to take such action as would protect the depositors in the Fort Dearborn National Bank and the Fort Dearborn Trust and Savings Bank, who, of course, have a prior claim to the entire assets of the two banks.

The officers and directors of the Fort Dearborn National Bank and the Fort Dearborn Trust and Savings Bank entered into negotiations, as a result of which the members of the Chicago Clearing House Association agreed to furnish guarantees to the extent of $2,500,000, satisfactory to the Continental and Commercial National Bank and the Continental and Commercial Trust and Savings Bank to protect them against loss.

Checks drawn against funds on deposit with the Fort Dearborn National Bank will be honored by the Continental and Commercial National Bank, and deposits in the Fort Dearborn National Bank will be credited on the books of the Continental and Commercial National Bank, while accounts in the Fort Dearborn Trust and Savings Bank will be taken care of by the Continental and Commercial Trust and Savings Bank.

The Chicago Clearing House Committee assures the depositors of both the Fort Dearborn National Bank and the Fort Dearborn Trust and Savings Bank that their interests have been fully protected, and that, owing to the arrangement entered into by the Chicago Clearing House Association with the Continental and Commercial National Bank and the Continental and Commercial Trust and Savings Bank, they will suffer no loss . . .

The conditions on which the Continental and Commercial banks took over the Fort Dearborn banks included the following:

1. The member banks of the Chicago Clearing House were to provide two guarantee funds, one of $1,000,000 to guarantee the Continental and Commercial National Bank against loss in liquidating the assets of the Fort Dearborn National Bank, and the other of $1,500,000 to guarantee the Continental and Commercial Trust and Savings Bank against loss in liquidating the assets of the Fort Dearborn Trust and Savings Bank. These funds were to be raised by a cash assessment on all the clearing house banks, the assessment being in proportion to the capital, surplus, and undivided profits of each bank. The Continental and Commercial banks were to bear their *pro rata* share in these funds. The money so raised was to be deposited with the Fort Dearborn banks, which were to give, in return, two-year notes bearing 5% interest from the date of deposit.

2. No general assessment was made against the stockholders of the Fort Dearborn banks, but in accordance with the terms of

an agreement entered into between these stockholders and the Continental and Commercial banks, certain directors and large stockholders of the Fort Dearborn banks were to subscribe to a guarantee fund aggregating $1,500,000, each one being liable to the extent of his individual subscription. In the event that the Continental and Commercial banks had not been able, by July 1, 1923, to pay off the liabilities of the Fort Dearborn banks, including the advances made by the members of the clearing house association, the subscribers to this fund would be called upon to pay part or all of their subscription, depending upon the amount of the deficiency. The liquidation of the assets of the Fort Dearborn banks proved to be quite satisfactory, and no payments on this guarantee fund were ever called for.

3. The business and all of the assets of the Fort Dearborn banks, with the exception of the building, were to be turned over to liquidating agents selected by the Continental and Commercial banks. These banks and agents were to make no charge for their services in liquidation, but were to have absolute discretion in regard to the renewal of loans and other matters connected with the conduct of such liquidation.

4. All of the liabilities of the Fort Dearborn banks, except the notes given in return for the guarantee funds provided by the clearing house banks, were to be assumed by the Continental and Commercial banks.

5. Payments from the funds realized by liquidating the Fort Dearborn banks were to be made as follows: first, to the Continental and Commercial banks until the full amount of the deposit liability of the Fort Dearborn banks on the date of absorption was discharged. (The liquidating agents were to pay 5% interest *on* the amount of such deposits from the date of absorption to the date, or dates, of repayment); second, to the clearing house banks, *pro rata*, in return for the guarantee funds provided by them, with interest at 5% from the date of deposit of these funds to the date of repayment; third, any residue to representatives of the stockholders of the Fort Dearborn banks for distribution among those stockholders.

6. The Continental and Commercial banks were to pay to the liquidating agents the following amounts *for* the deposits of the Fort Dearborn banks: (*a*) 5% of the net amount of time deposits of the Fort Dearborn banks remaining with the Continental and Commercial banks on August 1, 1922; (*b*) 3% of the average

net amount of demand deposits of the Fort Dearborn banks remaining with the Continental and Commercial banks between October 1 and December 31, 1922. No payment was to be made on the balances in new accounts opened with the Continental and Commercial banks by former customers of the Fort Dearborn banks, but credit was to be given for increases in the deposit balances of accounts originally taken over from the Fort Dearborn banks.

7. Any dispute between the Continental and Commercial banks, the liquidating agents and the representatives of the stockholders of the Fort Dearborn banks was to be referred for settlement to a committee made up of clearing house officials.

Enumerate the reasons why the Chicago Clearing House Association came to the aid of the Fort Dearborn banks. Did the clearing house association have any responsibility to do so?

Could the clearing house association have forced the Fort Dearborn banks to agree to being taken over by some other institution or institutions? If so, how?

Should a Chicago bank, strong enough to have withstood the failure of the Fort Dearborn banks, have agreed to contribute to the clearing house guarantee fund?

Does the fact that stockholders of the Fort Dearborn National Bank and the Fort Dearborn Trust and Savings Bank ultimately received liquidating dividends amounting to about 75% and 150%, respectively, of the par value of their shares, indicate that the consolidation of these banks with the Continental and Commercial banks was unnecessary?

Were the Continental and Commercial banks justified in agreeing to make the payments they did for the deposits of the Fort Dearborn banks? Should they have made any charge for their services as liquidating agents?

What alternative ways of saving the Fort Dearborn banks would have been open to the clearing house association in the event that none of its members had been willing to take them over?

32. GOVERNMENTAL SUPERVISION

BANK OF UNITED STATES

RESPONSIBILITY FOR THE FAILURE OF A LARGE BANK[1]

The Bank of United States[2] was founded in 1913 by Joseph S. Marcus, its first office being located on Delancey Street in the foreign district of New York City's lower east side. During the first 12 years of its existence the capitalization of the bank was increased from $100,000 to $2,000,000 and, in 1925 and 1926, from $2,000,000 to $5,000,000. In 1927 Joseph S. Marcus died and was succeeded, as president, by his son, Bernard K. Marcus, then 36 years of age.

With the passing of active control into the hands of the younger Marcus, the bank entered a period of spectacular growth which, within the space of 16 months, brought about a 400% increase in its capitalization. This expansion was carried out largely through mergers,[3] three banks with aggregate deposits of $158,000,000, as well as two smaller institutions, being absorbed in a single year.

After the acquisition of the Municipal Bank and Trust Company on May 13, 1929, the expansion of the Bank of United States

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[1] For a discussion of bank failures, consult: *Hearings before the Committee on Banking and Currency, House of Representatives, Seventy-first Congress, second session, under H. Res. 141*, pp. 4, 11–18, 51, 73–90, 418, 443–447; "The Causes of Bank Failures and Some Suggested Remedies," *American Bankers Association Journal*, November, 1927, pp. 304–308; Mosher, C. L., *The Causes of Banking Failure in the Northwestern States* (a pamphlet published by the Federal Reserve Bank of Minneapolis), *Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Sixty-ninth Congress, first session, on S. 1782 and H. R. 2*, pp. 143–148; *Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Seventy-first Congress, third session, pursuant to S. Res. 71; Annual Reports of the Comptroller of the Currency*, especially 1930, pp. 27–35; Bremer, C. D., *American Bank Failures;* Weidenhammer, Robert, "Better Bank Management: An Analysis of Fifty Bank Failures," *The Annals of the American Academy of Political and Social Science*, Vol. 171 (January, 1934), pp. 47–53.

On bank examinations, see: Kane, T. P., *The Romance and Tragedy of Banking*, Ch. XIV; Willis and Steiner, *Federal Reserve Banking Practice*, Ch. XXVI.

Consult: American Bankers Association, *Commercial Bank Management Booklet No. 6, Duties and Qualifications of Executive Bank Officers.*

[2] See Exhibit 1 for material regarding the bank's name and the granting of its charter.

[3] See Exhibit 2 for the merger history of the bank and statistics of growth.

abruptly ceased. There followed a period, from July 15, 1929, to December 10, 1930, when the bank was under surveillance by the New York State Banking Department.[1] A downward trend in its affairs, criticisms of its management and policies by state banking officials, and repeated attempts to merge it with other institutions[2] were the outstanding features of this phase of the bank's history.

On November 24, 1930, it was announced that the Bank of United States would merge with the Manufacturers Trust Company, the Public National Bank and Trust Company, and the International Trust Company. On December 8, however, it was rumored that these negotiations had been dropped. Unrest over the situation developed on that day and the next day. On December 10 runs took place at several of the bank's branches. At 9:00 A.M. on Thursday, December 11, Joseph A. Broderick, New York State Superintendent of Banks, announced that he had taken possession of the business and property of the bank.[3]

"The Bank of United States was the largest bank in the United States ever to suspend payments . . ."[4] At the time of closing it had approximately $160,000,000 of deposits, 400,000 depositors, 23,000 shareholders, and 1,884 employees exclusive of officers and directors. It operated 59 offices and controlled 60 subsidiary companies.[5]

Superintendent Broderick, in official testimony after the institution had closed, "blamed the bank's troubles upon ill-advised and unbusinesslike mergers with other banks, its connections with affiliates, and its real estate transactions."[6]

On December 27, 1930, T. C. T. Crain, District Attorney, promised a grand jury investigation into the conduct and management of the Bank of United States. State Attorney-General-elect J. J. Bennett also pledged himself to such an inquiry when he should take office on January 1, 1931.

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[1] See Exhibit 3 for examiners' reports on the bank in 1929 and 1930 and for criticisms by the New York State Banking Department.

[2] See Exhibit 4 for a summary of these attempts.

[3] See Exhibit 5 for the immediate reason for the suspension. The bank was closed under Section 57 of the New York State banking laws, by which the superintendent of banks may, among other causes, take over a bank "if it is in an unsafe or unsound condition to transact its business," or "if it cannot with safety and expediency continue business."

[4] *New York Times*, December 13, 1930. See Exhibit 6 for the statement and other material concerning the condition of the bank on the day before it was closed.

[5] See Exhibit 7 for a list of these subsidiary companies and for certain other information concerning them.

[6] *New York Times*, March 4, 1931.

In order to clarify the issues involved, consider, before reading Exhibits 1 to 7, the captions used in grouping the following:

Credit Policy.—Comment on the loaning policies of the Bank of United States as to diversification, security, and other recognized standards of sound credit policy.

Liability of Directors and Executive Officers.—Does it appear that the directors and executive officers of the bank solely were responsible for the failure?

Real Estate Loans.—To what extent did the large percentage of thrift and special interest accounts in the Bank of United States vindicate the policy in regard to making real estate and building loans? Comment on the recommendation of the New York State Banking Department that "all loans to own companies on real estate should be carried as real estate and not as loans."

Bonds.—Survey the bank's bond list and comment on the statement that these bonds were "among the strongest of the bank's assets" at the time it closed.

Liquidity.—Criticize the general liquidity of the bank and the adequacy of its reserves.

Expansion and Development.—Is it manifest that $19,600,000 in cash was an exorbitant price to pay for the Colonial Bank? In general, do the mergers entered into by the Bank of United States appear to have been ill advised?

Supervision.—Should Superintendent Broderick have closed the Bank of United States before December 11, 1930? Were the examinations of the bank adequate? Appraise the suggested changes in New York banking laws arising out of this case.

General Responsibility.—After making a careful survey of business conditions and developments in real estate values in 1928, 1929, and 1930, should one say that this bank failure was due to such *external* causes, or to weaknesses of *internal* management?

Branch Banking.—How can the fact of this failure be reconciled with the claim that branch banking (with or without geographical limits) will contribute to the elimination of bank failures in the United States?

Assistance of Other Banks.—To what extent can, should, and did the Federal Reserve Bank of New York aid? Did the New York City clearing house banks have or assume any responsibility in not averting the failure by a general contribution of cash, capital, or good management?

Qualifications of Officers and Directors.—What characteristics, abilities, and training are necessary to qualify a person as an efficient bank officer or director? Describe fully the methods followed in banking as practiced in the United States for testing, selecting, and appointing persons to official positions in banks. Do existing methods assure the selection of the most competent persons for such positions?

EXHIBIT 1*

Selection of Name, "The Bank of United States"

From the *New York Times*, February 18, 1930

Those who testified yesterday . . . [included] George C. Van Tuyl, Jr. former state superintendent of banks, who joined the bank's board after he had granted the charter and name of [The] Bank of United States . . . †

Mr. Van Tuyl, who was questioned at length by Mr. Steuer as to why he permitted the bank to carry a name which might have misled many persons into the belief that it was a government institution or had the support of the government behind it, said that this aspect of the matter had never come into his mind.

He offered in defense the assertion . . . that the banking department had not permitted the use of the bank's name until it had consulted with state officials, including the attorney-general, as well as the Attorney-General of the United States, none of whom, Mr. Van Tuyl said, had any objections . . .

The witness said that shortly before the application for the charter was made, residents of the east side had had "a terrible time" with private banks, many of which, he said, advertised in foreign languages that they were backed by one government or another. He intimated that the granting of a charter to a bank bearing the name "United States" was favored because this would tend to correct the aforementioned abuse . . .

To the suggestion of Mr. Steuer that the hanging of a picture of the Capitol at Washington in the bank office was intended to confuse further the minds of alien depositors, Mr. Van Tuyl smilingly replied that "it was only intended to help carry out the name of the bank."

* Throughout these exhibits changes have been made in newspaper quotations for some of the more obvious mistakes. These changes have not been indicated in the quotations.

† By an act of Congress passed May 24, 1926 (National Bank Act, Ch. V, §534, Sec. 2) it was made unlawful for any bank to use the words "United States" as a part of its name.

EXHIBIT 2

Bank of United States, Growth and Mergers

Table 1

Increases in Capitalization since January 1, 1928

Date	Increased From	Increased To
January 16, 1928	$ 5,000,000	$ 6,000,000
May 18, 1928	6,000,000	8,333,400
August 25, 1928	8,333,400	8,933,400
December 15, 1928	8,933,400	17,866,800
March 25, 1929	17,866,800	20,875,000
May 9, 1929	20,875,000	25,250,000

EXHIBIT 2. (*Continued*)

Table 2

Selected Figures on Dates of Call, December 31, 1928, to September 24, 1930*

Dates	Capital, Surplus, and Undivided Profits	Deposits	Total Resources	Book Value of Stock†	Market Price‡	
					Bid	Asked
Dec. 31, 1928	$29,273,384	$156,782,326	$191,740,463	$41	195	200
March 22, 1929	29,460,386	151,747,084	190,819,683	41	220	225
June 29, 1929	40,521,471	229,757,777	293,134,886	40	196	198
Sept. 27, 1929	40,995,268	238,086,499	303,255,528	41	179	181
Dec. 31, 1929	41,485,590	225,664,711	276,561,824	41	66	68
March 27, 1930	41,913,596	211,241,603	263,113,075	41	81½	83
June 30, 1930	42,274,819	211,800,366	261,741,770	42	44	45
Sept. 24, 1930	42,406,375	202,972,469	254,043,942	42	38	39½

* Reprinted from the *New York Times*, December 12, 1930.

† The book values here quoted refer only to those of Bank of United States shares. The *New York Herald Tribune* of January 22, 1931, stated that, in the summer of 1929, the book value of each unit was $62. A part of this represents book value of the shares of the Bankus Corporation.

‡ Price of units consisting of one share of Bank of United States and one share of Bankus Corporation stock.

Table 3

Statements of Condition, as of December 31, 1927 to 1929, and September 24, 1930

	December 31, 1927	December 31, 1928	December 31, 1929	September 24, 1930
Resources				
Cash in Vault and in Banks	$ 22,472,291	$ 26,950,400	$ 47,846,304	$ 31,862,516
Bonds and Other Investments	25,200,005	35,309,711	37,761,065	42,069,137
Collateral and Call Loans	18,530,942	52,226,634	51,147,232	48,410,750
Discounts	38,734,771	73,694,087	131,189,848	123,237,235
Banking House	1,442,021	1,769,917	4,855,900	5,230,760
Accrued Interest Receivable	217,899	395,359	565,796	876,760
Customers' Liability on Acceptances	1,151,192	1,394,355	3,195,589	2,356,778
Total	$107,749,121	$191,740,463	$276,561,824	$254,043,942
Liabilities				
Capital	$ 5,000,000	$ 17,866,800	$ 25,250,000	$ 25,250,000
Surplus and Undivided Profits	5,233,755	11,406,584	16,235,590	17,156,375
Reserves for Dividends, Taxes, Interest, Etc.	1,396,685	3,252,598	5,123,289	5,081,208
Unearned Discount	377,203	635,122	997,276	783,062
Deposits	94,540,385	156,782,326	225,664,710	203,035,613
Liability as Acceptor, Endorser, or Maker of Acceptances	1,201,093	1,797,033	3,290,959	2,737,684
Total	$107,749,121	$191,740,463	$276,561,824	$254,043,942

Mergers Entered into by the Bank of United States

1. Central Mercantile Bank and Trust Company, May 21, 1928.—On December 31, 1927, this bank had capital, surplus, and undivided profits of $6,717,092, and deposits of $54,237,177. It was operating five branch offices. One share of Bank of United States stock was exchanged for each one and one-half shares of Central Mercantile Bank and Trust Company stock.

2. Cosmopolitan Bank, August 27, 1928.—On December 31, 1927, this bank had capital, surplus, and undivided profits of $1,008,705, and deposits of $11,071,249. Exchange for Bank of United States stock was on a share for share basis.

EXHIBIT 2. (*Continued*)

3. Colonial Bank and Bank of the Rockaways, April 1, 1929.—On December 31, 1928, the Colonial Bank had capital, surplus, and undivided profits of $5,365,404, and deposits of $37,000,436.* It operated 15 branches. On April 1 the Bank of the Rockaways had a capital of $100,000.

4. Municipal Bank and Trust Company, May 13, 1929.†—On December 31, 1928, this bank had capital, surplus, and undivided profits of $12,261,624, and deposits of $66,509,552. Of its 20 branches, 16 were located in Brooklyn. Three and a half Bank of United States units were exchanged for each share of Municipal Bank and Trust Company stock.

* An interesting aspect of this merger was that the Bankus Corporation and the City Financial Corporation purchased the entire common stock of the Colonial Bank before the institutions were actually consolidated. The *New York Times* of February 4, 1931, attributed to Bernard K. Marcus the statement that these subsidiaries paid $19,600,000 in cash for the 14,000 shares of Colonial Bank stock outstanding at the time. The statement of condition of the Colonial Bank, as of December 31, 1928, follows:

Resources		Liabilities	
Cash	$ 3,160,781	Capital Stock	$ 1,400,000
Cash Items	2,755,762	Surplus	3,600,000
Due from Banks	1,378,670	Undivided Profits	365,404
Stocks and Bonds	1,502,116	Demand Deposits	29,418,066
Mortgages Owned	441,400	Time Deposits	7,582,370
Secured Loans and Discounts	10,240,139	Checks Outstanding	283,836
Unsecured Loans and Discounts	22,123,700	Unpaid Dividends	84,693
Real Estate and Building	1,420,467	Unearned Discount	173,653
		Accrued Interest	52,306
		Reserve for Taxes, Etc.	62,707
Total	$43,023,035	Total	$43,023,035

Sale prices of stock: 1925, $662; 1926, $1,000; 1927, $1,100; 1928, $1,400. Book value per share, December 31, 1928 (14,000 shares outstanding), $383.24.

† From the *New York Times*, February 19, 1931. ". . . The Bank of United States purchased the Colonial Bank and the Municipal Bank [and Trust Company]. According to Mr. Steuer, the price paid for the first was $19,600,000 for assets worth only $6,400,000, and for the second $16,000,000 for assets valued only at $10,000,000."

From the *New York Herald Tribune*, February 3, 1931. "The absorption of the Municipal Bank and Trust Company and its affiliate, the Municipal Financial Corporation, by the Bank of United States group in May, 1929, was described . . . as 'unfortunate,' in the light of recent events by Bernard K. Marcus . . . testifying before Referee Robert P. Stephenson . . . in an investigation into the affairs of four bankrupt Bank of United States affiliates . . .

"James N. Rosenberg, attorney for the Irving Trust Company, receiver and trustee of the four bankrupt corporations, tried to get Mr. Marcus to concede that the Bank of United States had paid $7,000,000 too much for the two 'Municipal' companies . . .

"Denying an overpayment . . . Mr. Marcus pointed out that 'although this $7,000,000 was more than the asset value of the Municipal Bank, it corresponded to a market price' for the institution . . . "

EXHIBIT 3

Examiners' Reports and Criticisms by State Banking Officials

Examiners' Report, 1929

From the *New York Times*, March 4, 1931

(Statement of Joseph A. Broderick, New York State Superintendent of Banks)

The present superintendent of banks took office on April 22, 1929.

The Bank of United States was the first large bank to be examined during his term. The reason for this selection was that, not long prior to the appointment of the superintendent, the bank had absorbed, by merger, three other institutions, all of which, like the Bank of United States itself, had given considerable attention to the real estate field. It seemed desirable not to ignore the doubts natural in such circumstances as to the ability of the bank to effect within a few months such readjustments as good banking practice would require . . .

. . . The examination . . . began on July 15, 1929 . . .

On August 29, 1929, a copy of the examiners' report, both of the bank and

EXHIBIT 3. (*Continued*)

of the Bankus Corporation and its affiliates, was delivered to Messrs. Marcus, Singer, and Kresel . . .

The examiner in charge had not written off any substantial amount, nor had he raised any question as to the financial condition of the bank, but he had drawn attention to certain apparent violations and to certain practices and policies. The weakness inherent in the combination of three real estate banks had become evident to the department, and it also appeared that relations with the Bankus Corporation were such as to call for watchfulness and careful supervision.

From the *New York Herald Tribune*, January 22, 1931

This report showed charged-off loans amounting to $716,943; doubtful loans, $1,447,199; and slow loans, $6,325,582. There were listed also for "special mention" loans amounting to $12,659,000.

Among the criticisms and recommendations made by the superintendent of banks in this report were that:

1. Effort be made to reduce real estate bonds.
2. Loans to subsidiaries "amounting to millions" be reduced.
3. All loans to own companies on real estate be carried as real estate and not as loans.
4. Reduction be made in real estate holdings.
5. No loans be made to enable purchasers to buy Bank of United States stock units . . .

"This bank is having difficulty supporting its stock," ran the examiner's comment, "which is not a healthy condition."

From the *New York Times*, March 4, 1931

. . . The superintendent was given assurances:

1. From Messrs. Mitchell and Kugel that they would take a more active part in the affairs of the institution and be watchful of its activities . . . *
2. That the real estate policy of the bank would be checked.

Examiners' Report, 1930

From the *New York Times*, March 4, 1931

(Statement submitted by Joseph A. Broderick, New York State Superintendent of Banks)

Beginning on June 24, 1930, a general examination of the bank, the Bankus Corporation, and other subsidiaries was made by the senior examiner and a staff of 128 assistants . . .

The report was completed on September 15, 1930, and, on September 19, a copy was delivered by the superintendent to Messrs. Marcus, Kugel, and Singer. They were informed that it was drastic and that a discussion was desired at the earliest possible moment . . .

The superintendent stated that he did not intend to discuss the details of the report, but rather how to put the bank in a proper condition, and that, in his opinion, this could be effected only by a merger. The bank's officers expressed disagreement with the examiners' findings but yielded to the department's insistence upon an agreement, then and there, that merger negotiations would be undertaken immediately.

From the *New York Herald Tribune*, January 22, 1931

. . . Mr. Steuer then read into the record the examiner's report in which . . . the examiner had criticized $14,111,866 [of loans], had classed $14,085,366 as "slow," and $9,321,038 as "doubtful."

* Marcus and Saul Singer, President and Chairman of the Executive Committee, respectively, had been connected with the Bank of United States for some time. C. Stanley Mitchell, chairman of the board, had come to the bank from the presidency of the Central Mercantile Bank and Trust Company. Simon H. Kugel, vice chairman of the board, formerly had been chairman of the board of the Municipal Bank and Trust Company.

EXHIBIT 4

Attempts to Merge the Bank with Other Institutions

From the *New York Times,* March 4, 1931

(Statement of Joseph A. Broderick, New York State Superintendent of Banks)

. . . On September 28 the department learned that Mr. Marcus had opened conversations with a large private banking firm, and on October 1, 1929, representatives of both interests called at the office of the superintendent and discussed the pending negotiations. The plan contemplated the purchase of 100,000 Bankus Corporation units at $180 per unit . . . Under this arrangement the policy and management of the bank and the Bankus Corporation would have been under new direction.

. . . On October 22 the department was advised of their termination. The date will be identified with that of the first Stock Exchange crash . . .

. . . Then [in March, 1930], and in April, approaches were made by a large trust company, but as there was, at that time, a substantial advance in the quoted values of the stock of the bank, the trust company did not pursue the matter further. The chairman of another large institution intimated to the superintendent a possible interest in a merger but felt that action should be deferred until the general situation was more settled.

During the summer months, at different times, two bankers indicated a desire to bring about a combination of three state institutions and one national bank. Since all the institutions did a similar business, they were hopeful that by effecting economies, after a merger, the combined institutions could be placed on a sound and stable basis. Both gentlemen were advised to deal directly with the parties in interest. It was added that, in the judgment of the department, it would be best that the Bank of United States should merge with an institution that fully understood the type of business conducted by the Bank of United States, and, in particular, its real estate business . .

Late in September the bank was approached by those interested in effecting the four-company merger. On October 28 and 29 newspapers carried information concerning this project. It was then the understanding that an acceptable basis had been reached, but that details were still to be adjusted.

At this time, or a little later, the bank, with the full knowledge of all concerned, was negotiating with two independent interests.

Early in October negotiations were opened with a large trust company and continued for several weeks. These were dropped, later on, because of a difficulty encountered in coming to an agreement as to a satisfactory basis for the exchange of stock. The Bank of United States people may have overtraded in these preliminaries. It was understood, however, that if the four-company merger were not concluded, the trust company would be willing to renew negotiations.

On November 10 the representatives of the two principal companies in the proposed four-company merger advised the Bank of United States officials that, with market conditions as they then were, they did not see how they were going to be able to work anything out. Later, the same gentlemen advised the superintendent of banks and the chairman of the Federal reserve bank that they were not going ahead.

In this conversation they intimated they had understood that it was a community proposition, and that they had expected to receive some support from other banks if they went in .

From November 10, and until 2:30 A.M., December 11, 1930, conferences were held almost continually, seeking to find an acceptable solution. . . .

On November 11 the superintendent and representatives of the Bank of United States endeavored to revive negotiations with the first-mentioned trust company. It was ascertained, however, that, without any commitment on the part of that institution, it had been asked by outside interests to take the Bank of United States on a liquidation basis, and it was stated that in this the trust

EXHIBIT 4. (*Continued*)

company might or might not be interested, but that certainly it would not be interested on a stock basis . . .

Intimations were then received that a deal might still be arranged with the four companies. Meetings were held with the boards of directors of the two principal companies in the four-company merger, and on November 16 a proposition was tentatively submitted by these companies, subject to certain conditions. This [plan] would have allowed for a merger on the basis of an exchange of stock. The Bank of United States' officials were disposed to accept this proposition immediately, but upon consulting with representatives of the other companies in the merger, the officials of the Bank of United States were told that the discussions would have to be deferred . . .

Then the officials of the Bank of United States renewed direct conversations and negotiations with the first-mentioned trust company . . .

. . . At the suggestion of a group of bankers, the superintendent submitted a proposition to representatives of the Bank of United States, under which the first-mentioned trust company would agree to assume and take over all liabilities of the Bank of United States and to make a loan secured by the assets of such institution, the proviso being that the associated banks would take and subordinate a substantial interest in such loan. This plan provided for the protection of depositors and the preservation of the stockholders' equities. Moreover, stockholders would have had the benefit of an able management in working out a very unsatisfactory condition. With certain modifications this [plan] was agreed to by the officials of the Bank of United States.

In drawing the agreement, on November 22, obstacles were met . . . which could not be overcome. These related principally to the right of the trust company to withdraw in the event of a material change in the condition of the Bank of United States prior to the approval by the stockholders of said Bank of United States of the . . . [agreement.]

On November 23 negotiations with respect to the four-company merger were again renewed. Representatives of the two principal institutions in the four-company merger advised that they were prepared to go ahead and merge the four institutions. Discussions as to terms continued until Monday morning, and an agreement was arrived at which would have given to each individual stockholder, other than the Bankus Corporation, for each unit held, one-fifth of a share of the stock of the merged institution, plus warrants to subscribe to an equal number of shares at a fixed price. Further provisos were made with respect to resignations of officers and directors of the Bank of United States, the cancellation of outstanding salary contracts, and the giving of guarantees by certain officers of the Bank of United States with respect to lawsuits. On the basis of this agreement, the chairman of the Federal reserve bank consented to become chairman of the merged institution, and four prominent New York City bankers agreed to become directors . . .

All the interested parties agreed to the following statement . . . at 9:00 A.M., November 24, and . . . [later] released to the newspapers:

"The proposed merger of the Manufacturers Trust Company, the Public National Bank and Trust Company, the Bank of United States, and the International Trust Company took definite form over the week-end, when a tentative plan and basis of merger was agreed upon, subject to ratification by the respective beards of directors and stockholders of the institutions.

"Upon such ratification becoming effective, Mr. J. Herbert Case, now Chairman of the Board of Directors of the Federal Reserve Bank of New York, will join the enlarged institution as its head. Mr. Mortimer N. Buckner [chairman of the board of the New York Trust Company and chairman of the clearing house committee], Mr. Walter E. Frew [chairman of the board of the Corn Exchange Bank and Trust Company], Mr. George W. Davison [president of the Central Hanover Bank and Trust Company], and Mr. P. A. Rowley [vice chairman of the board of the Bank of Manhattan Trust Company] will become members of the board of directors. Mr. Nathan S. Jonas and Mr. Henry C. Von Elm, now respectively chairman of the board and president of Manu-

EXHIBIT 4. (*Continued*)

facturers Trust Company, will remain in important positions. Mr. E. Chester Gersten, now president of Public National Bank and Trust Company, will become president of the new institution.

"Application will also be made for membership in the New York Clearing House Association, and on the basis of the individual statements of the four institutions, the new bank, with deposits of over $700,000,000 and resources of nearly $1,000,000,000, will rank fourth in size among the banks in New York City."

This statement was well received and widely commented upon by the press. The plan was one that met with the support and commendation of the entire banking community. Lawyers were designated to draw up the agreement, but during the next 10 days the progress made with respect to the agreement was very slow, although all reasonable pressure was being brought to bear to have the matter cleared and not dragged as previous negotiations had been. On December 7 information was given that one party to the agreement had submitted new conditions, not contemplated at the time of the original agreement, and impossible of fulfillment.

On the following day, December 8, other plans were considered. One was to merge a trust company with the Bank of United States, but this [proposal] was definitely dropped. Then followed a plan to continue the bank under entirely new management and new capital, to be supplied by the other banks. Another trust company gave consideration to taking over the Bank of United States. A national bank studied the proposition with the assistance of outside real estate interests. Negotiations on these projects continued through December 10. All that day, also, a meeting of the bankers was in session. The trust company deal fell through on the evening of December 10. The national bank deal was called off in order to clear the way for a new proposition, which was as follows:

Associated banks were to subscribe to an amount of $30,000,000 of the new capital, and the present capital of the Bank of United States was to be reduced to $2,500,000. This would give the reorganized bank a capital of $17,500,000 and a surplus of $15,000,000. The bank was to have new management and new directors. Information was given that this stock was subscribed for late that evening. The agreements were drawn and most of the principal bankers in New York were still in session. A newspaper article outlining this deal was in preparation, and the newspaper men were invited to call at the Federal reserve bank between 9:00 and 9:30 o'clock that evening. At about 11:30 o'clock the superintendent was informed that some one or two bankers did not want to go along, and that there was no prospect of going ahead unless all the bankers agreed. Thereupon the superintendent requested, and, at about 1:00 A.M. on December 11, was granted the opportunity of speaking to the assembled bankers. The situation was frankly discussed; the effects of the closing of the bank on the depositors and customers, on other banks, and on the community were pointed out, as well as the effect on the country and foreign nations of a bank with this name being permitted to go under. The results of a forced liquidation, which from past experiences would mean an automatic marking off of from 20% to 33⅓% of the assets, were indicated. But the superintendent was informed that the decision was final.

EXHIBIT 5

Immediate Reason for Suspension*

From the *New York Times*, March 4, 1931

(Statement submitted by Joseph A. Broderick, New York State Superintendent of Banks)

After the announcement of the four-party merger, as is usual in such cases a readjustment of depositors' accounts at the Bank of United States was being made, and there was a general reduction in the deposit liability of the bank, due to the transferring of accounts to other institutions, [a procedure] which,

EXHIBIT 5. (*Continued*)

in view of all the circumstances involved, was considered normal. However, the rumors involving the Bank of United States gathered cumulative effect during December 8, 9, and 10, until, late on December 10, 1930, runs developed in several of the branches of this institution, resulting in direct withdrawals of over ten millions of dollars on that particular date, as well as a tremendous increase in the exchanges, which would have resulted in additional loss of many millions of dollars had the bank remained open on December 11. It was apparent to the superintendent that unless immediate steps were taken to see that all depositors were treated equally, the liquid assets of the institution would be given out to those who first applied, and the less liquid assets would be left for other depositors who failed, or were unable, to present their claims. So that all persons, those having large accounts as well as those having small accounts, might be treated on the same footing, it was vitally necessary that some solution of the problem of the Bank of United States be reached on the night of December 10. With all other alternatives taken away, the only step left possible for the superintendent was to close the institution.

After the conclusion of the meeting with the bankers, the directors of the Bank of United States presented to the superintendent a resolution requesting that the department take possession of the bank. At their invitation the superintendent met with them about 4 A.M. on December 11. The bank was closed at 9 A.M., at which time representatives of the department took possession of all the offices of the bank.

* From the *New York Sun*, December 11, 1930. "Federal reserve bank aid was extended to the limit, but the amount of Federal reserve credit which may be extended is limited by the amount of eligible paper . . . [owned]."

From the *New York Times*, January 23, 1931. "Questions put to Mr. Case [chairman of the board of the New York Federal Reserve Bank] concerning the failure of the Bank of United States brought the reply that it had not been a borrower at the reserve bank for a considerable part of the recent years. He said the reserve bank had known of bad practices at the Bank of United States for a number of years, and that President Marcus . . . had been interviewed in an attempt to correct conditions." (*Cf. Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Seventy-first Congress, third session, pursuant to S. Res. 71*, p. 116.)

EXHIBIT 6

Bank of United States, Condition on December 10, 1930

Table 1

Statement of Condition*

Resources	
Cash	$ 10,519,650.29
Due from Banks	20,831,088.97
Checks Payable at Other Banks	2,349,957.80
Foreign Currency	13,438.77
Stock and Bond Investments	23,690,777.68
Mortgages Owned	8,585,183.94
Building Loans	8,518,761.49
Loans	148,026,997.56
Accounts Receivable	760,577.03
Banking Houses and Leasehold Improvements	4,427,210.15
Furniture and Fixtures	2,173,678.10
Prepaid Expenses	134,522.46
Accrued Interest Receivable	773,885.49
Customers' Liability under Acceptances	1,802,642.30
Acceptances of Other Banks Endorsed by Bank of United States	5,162,203.64
Overdrafts	93,361.90
	$237,863,937.57

* From the *New York Times*, February 2, 1931.

EXHIBIT 6. (*Continued*)

Table 1. (*Continued*)

Liabilities

Capital Funds	$ 47,800,610.32
Reserves	829,696.18
Demand Deposits	66,132,215.87
Special Interest Deposits	89,710,538.16
Due to Banks	925,526.01
Certificates of Deposit	1,034,420.18
Check Liabilities	3,675,672.88
Other Deposits	360,311.02
Other Time Deposits	717,414.50
Trust Deposits	670,668.92
Secured Deposits	42,017.59
Liability as Acceptor, Endorser, or Maker on Acceptances	6,964,845.94
Bills Payable	19,000,000.00
	$237,863,937.57

From the *New York Times*, February 2, 1931

Loss, impairment, or "freezing" of about $75,000,000, or nearly a third of its assets, compelled the closing of the Bank of United States, it was shown yesterday by the publication by the [New York] State Banking Department of an inventory of the bank's resources, as of December 10, 1930 . . .

The largest items of loss revealed through the inventory are loans to affiliates totaling $24,726,381, and some $13,000,000 in weak and questionable loans. With the exception of a small part, the loans to affiliates are regarded as lost. Only the future can tell how many of the bad loans will be collected, bank examiners declared.

The inventory also sets forth that $17,103,945.43 of the bank's resources are tied up in "frozen" and "slow" mortgages and building loans . . . Of the total mortgages of $8,585,183.94, about 50% are junior, or second and third mortgages, regarded as "slow." The item of $8,518,761.49, covering building loans, is regarded as "frozen" because of the prevailing depression in the building industry . . .

In addition to the factors enumerated, an item of $6,735,810.71, covering banking property, leasehold improvements, and prepaid expenses, is regarded as worth little, if anything, unless the bank is reopened.

There is also a questionable item of $1,802,642.50, entitled "customers' liability under acceptances," the collection of which is considered difficult because of intricate legal complications.

The item of accounts receivable, appearing in the inventory and totaling $760,577.03, includes claims resulting from defalcations by employees, amounts due from bankrupt affiliates, and sums due from purchases for accounts of customers, secured, in some cases, by bank stock units.

The value of the bank's stocks and bonds, given in the inventory as $23,690,777.68 . . . cannot be determined until after final liquidation, although this item is considered as among the strongest of the bank's assets.

EXHIBIT 6. (*Continued*)

Table 2

Bond and Stock Investments*

Par Value	Bonds	Book Value
$1,525,600	United States Government, Treasury Bonds, and Treasury Notes	$ 1,587,676.13
1,571,000	New York City Bonds and Corporate Stock	1,225,086.55
603,000	New York State Bonds	619,140.81
3,262,000	Railway and Traction Company Bonds	3,047,575.99
213,000	Monterey Holding Corporation	206,820.00
50,000	98 Riverside Drive Apartments	49,250.00
30,000	Wade Park Manor Company	29,925.00
10,000	Fifth Avenue and Twenty-ninth Street Corporation	27,475.00
1,150,000	Conqueror Holding Corporation	1,137,500.00
19,000	Saks Realty Corporation	19,041.00
25,000	Herald Square Building	24,250.00
245,000	68 Sixth Avenue Corporation	245,000.00
389,000	Oltarsh Building	383,232.50
883,000	Court and Montague Streets Realty Corporation	861,040.00
5,000	National Tower Building	4,975.00
3,459,400	Garment Center Capitol	3,447,430.00
522,500	Southeastern Hotels	522,500.00
144,000	Dinard Holding	143,230.00
396,000	Ganadeen Realty	396,500.00
85,000	Kobler Dinard Holding	80,750.00
144,000	Kobler Holding	143,560.00
	Other Bonds	6,502,918.35
	Total Bonds	$20,704,876.33

Number of Shares	Stocks	Book Value
6,600	Federal Reserve Bank	$ 330,000.00
14,550	Federal Reserve Bank	727,500.00
4,994	City Safe Deposit Company (Common)	564,334.00
2,495	Colonial Safe Deposit Company	249,500.00
300	Continental Shares (Preferred)	29,625.00
1,555	Italian Superpower Corporation (Common)	17,577.50
1,994	Municipal Safe Deposit Company (Common)	748,650.00
2,500	Mutual Trust Company (Common)	250,000.00
250	Seaboard Public Service Company (Preferred)	23,625.00
300	Spiegel-May-Stern Company, Inc. (Preferred)	28,050.00
1,850	Miscellaneous Companies	50,000.00
	Total Stock Holdings	$ 2,968,866.50

* As published in the *New York Times*, February 2, 1931. No attempt has been made to verify the additions in this table, or to reconcile the totals with those shown in the balance sheet in Table 1.

EXHIBIT 6. (*Continued*)

Table 3

Classification of Total Loans of $100,000 or More to a Single Borrower, as of December 10, 1930*

Type of Customor	Security	Number of Loans	Amount	
Subsidiary Companies	Unsecured	28	$22,374,020.66	
	Secured	3	1,832,510.00	$24,206,530.66
Individuals	Unsecured	34	5,011,680.00	
	Secured	32	7,177,696.00	
	Notes Discounted	10	501,007.00	12,690,383.00
Real Estate and Construction	Unsecured	30	5,685,329.00	
	Secured	8	2,246,737.38	
	Notes Discounted	1	139,500.00	8,071,566.38
Financial	Unsecured	9	1,850,000.00	
	Secured	6	1,472,889.00	3,322,889 00
Clothing Manufacture	Unsecured	8	1,675,000.00	
	Secured	1	185,000.00	
	Notes Discounted	2	261,026.00	2,121,026.00
Coal	Unsecured	3	1,100,000.00	
	Notos Discounted	2	154,508.00	1,254,508.00
Printing and Publishing	Unsecured	3	540,000.00	
	Secured	1	273,661.00	813,661.00
Clothing Stores	Unsecured	3	750,000.00	750,000.00
Miscellaneous	Unsecured	14	3,380,712.00	
Iron and Steel (3)	Secured	3	921,398.00	4,302,110.00
Public Utilities (2)				
Electrical Appliances (2)				
Food (2)				
Hospital (1)				
Oil (1)				
Automobile (1)				
Rubber (1)				
Soap (1)				
Jewelry (1)				
Toys (1)				
Theater (1)				
Unclassified	Unsecured	8	857,475.00	
	Secured	3	294,539.00	
	Notes Discounted	1	87,881.00	1,239,895.00
				$58,772,569.04

* The loans separately listed in the *New York Times*, February 2, 1931, have been classified, with the aid of Dun's *Reference Book*, to form this table. This grouping, however, is liable to error since, in an attempt to classify as many of the loans as possible, certain companies which could not be identified positively were placed elsewhere than in the unclassified group.

Recapitulation

Number of Customers	180
Number of Loans	213
Total Unsecured Loans	$43,224,216.66
Total Secured Loans	14,404,430.38
Total Notes Discounted	1,143,922.00
Total Loans	$58,772,569.04

EXHIBIT 7

Affiliates and/or Subsidiary Companies of Affiliates

From the *New York Times*, January 9 and February 2, 1931

Abenad Realty
Active Property
Antur Holding
Arnat Leasing
Avran Holding
Bankus
Barbes Realty
Beverwyck Holding
Bolivar Development
Broadway Continental
Charonne Development
Chaumont Development
Chesterford Realty
City Financial
City First Mortgage & Title
City Safe Deposit
Claremont Development
Clarence Holding
Colonial Safe Deposit
Consolidated Indemnity and Insurance
Delaware Bankus
Duroc Holding
Grenelle Holding
Jourdan Holding
Landberry Holding
Lamarch Holding
Lenoir Holding
Manhattan Square Beresford
Maubert Holding
Merit Mortgage
Messine Holding
Minerva Development
Monceau Holding
Municipal Financial
Municipal Safe Deposit
101 Wall Street
Premior Development
Raneleigh Holding
Rella Development
Rex Leasing
Rurik Holding
San Remo Towers
70 Wall Street
Southford Holding
Stonepit Holding
Storm Development
Sulpice Holding
Sun Holding
Tourmont Realty
Townsite Holding
Tremont Development
Trudaine Development
Vanfred Realty
Vendome Holding
Villette Holding
Vincennes Holding
Wagram Holding
Warwick Development
Westford Development
York Investing

Forty of these 60 subsidiaries were listed by the *New York Times*, February 2, 1931, as being indebted to the Bank of United States on the day before it was closed. Total loans to subsidiaries on that date were $24,726,381, while $123,910.73 was due, in the form of accounts receivable, from 4 of these companies.

On December 31, 1930, the Bankus Corporation, City Financial Corporation, Delaware Bankus Corporation, and Municipal Financial Corporation filed voluntary petitions in bankruptcy. The Irving Trust Company was appointed receiver, and bankruptcy proceedings were instituted before Robert P. Stephenson as referee.

The *New York Times*, February 27, 1931, gave the assets of the Municipal Financial Corporation as $11,321,945, and its liabilities as $10,356,485. In the case of the Delaware Bankus Corporation, assets were $261,445, and liabilities, $447,255. Speaking of the Municipal Corporation, the same paper said, "Among the assets are listed accounts receivable in large part from subsidiaries and persons who were active in their affairs. Among the securities are many blocks of capital stock shares issued by subsidiaries. The same is true as to the Delaware Bankus schedule."

FEDERAL RESERVE BANK OF MINNEAPOLIS

JUDGING BANKS AND BANK MANAGEMENT[1]

In 1926 the statistical staff of the Federal Reserve Bank of Minneapolis initiated a scientific project designed to discover criteria of efficient bank management. The source material available for analysis consisted of copies of the reports of examinations of member banks prepared by national and state bank examiners. The reports furnished a large part of the information upon which decisions were made regarding requests for rediscounts and were used by banking supervisory authorities as a basis for disciplinary action.

For a number of years significant ratios were computed from the data contained in the reports and tabulated on cards for each member bank. By grouping the cards according to numerous classifications, such as by open and closed banks, it was possible to determine norms, related conditions, and the characteristic measures or ratios of strong and of weak banks. The history of a single bank became available for use in making case studies, and general surveys of banking conditions on different dates were made so as to ascertain precisely the general trends and the contemporary situation. To illustrate the method of analysis and its possibilities for use in passing on bank loans and in supervising banks with reference to the maintenance of adequate solvency, Exhibits 1 and 2 are presented, the former for an operating member bank, and the latter for a member bank that closed in 1932.

From the two exhibits determine, so far as possible, the standards on the borderline between good and weak banks.

Upon what specific dates, if any, did either of these banks appear to be in the danger zone of insolvency?

Upon what dates would requests for borrowed funds appear to have merited approval?

[1] For the relation of bank examinations to solvency, see *Annual Report of the Federal Deposit Insurance Corporation*, 1934, pp. 14–20, 44–50. For the procedure in bank examinations with reference to appraisal of bonds and the treatment of profits on sales of securities, see case of Miller National Bank, *supra*.

EXHIBIT 1

Part I. Degree of Solvency of Member Bank A

Date of Examination (Month and Year)	Capital (In Thousands of Dollars)	Surplus (In Thousands of Dollars)	Total Deposits (In Thousands of Dollars)	Total Loans and Investments (Excl. Circul. Bonds) (In Thousands of Dollars)	1. Losses (−)	2. Doubtful Assets (−)	3. Slow Loans and Slow Securities (Foreclosures, Claims, Judgments, Defaulted Bonds, etc.) (−)	4. Banking House, Furniture, and Fixtures (−)	5. "Other Real Estate" (At Book Value) Reported as Slow (−)	6. Estimated Value of "O.R.E." Less Book Value and Less Prior Liens (+ or −)	7. Other Concealed Assets Including Appreciation on Bonds (+)	8. Undivided Profits Plus Reserves for Losses & Depreciation, Less Expenses in Excess of Earnings (+ or −)	9. Solvency Ratio (Net Sum 1–8) (+ or −)
					As % of Capital and Surplus								
2–26	100	20	1,324	1,056	..	...	....	23.3	2.5	+.2	3.3	+13.3	− 9.0
8–26	100	20	1,506	1,312	..	...	1.7	23.3	2.5	+.2	8.3	+15.8	− 3.2
1–27	100	20	1,480	1,456	..	...	1.7	22.0	2.7	...	8.2	+17.3	− .9
9–27	100	20	1,660	1,488	..	.	....	21.7	...	...	2.5	+15.0	− 4.2
2–28	100	20	1,744	1,640	..	.	....	21.0	...	...	1.7	+20.0	+ .7
9–28	100	20	1,712	1,644	..	6.2	....	21.7	...	...	....	+40.0	+12.1
2–29	100	20	1,658	1,526	..	...	...	20.0	..	...	....	+47.5	+27.5
7–29	100	20	1,410	1,316	..	...	14.5	20.0	...	..	....	+55.5	+21.0
1–30	100	20	1,488	1,486	..	...	....	28.3	...	...	....	+60.0	+31.7
10–30	100	80	1,392	1,316	..	...	...	18.9	...	...	5.0	+12.8	− 1.1
4–31	100	80	1,680	1,546	..	...	..	17.8	...	...	6.1	+14.4	+ 2.7
12–31	100	80	1,638	1,490	..	...	..	17.8	...	...	....	+12.2	− 5.6
4–32	100	80	1,594	1,332	..	...	..	16.7	...	...	..	+12.2	− 4.5
11–32	100	80	1,544	982	..	..	....	16.7	..	...	...	+13.3	− 3.4
5–33	100	80	1,876	1,248	..	...	...	16.1	.	...	...	+ 8.1	− 8.0
3–34	100	80	2,394	1,504	..	...	....	15.3	...	...	...	+13.8	− 1.5
8–34	100	80	2,934	1,440	..	..	....	15.3	.	...	..	+13.4	− 1.9
1–35	100	80	3,662	1,432	..	..	....	13.9	...	...	10.0	+13.4	+ 9.5

EXHIBIT 1. (*Continued*)

Part II. Credit Policy and Administration of Member Bank A

Date of Examination (Month and Year)	As % of Capital and Surplus					As % of Capital	As % of Capital and Surplus				As % of Total Deposits
	Total Borrowed Money and Borrowed Bonds	Loans to Directors and Officers (Direct)	Loans Endorsed or Guaranteed by Directors and Officers	Loans to Directors' and Officers' Interests	Deposits per Dollar of Book Capital	Stock Owned by Directors	Net Earnings before Writeoffs and Recoveries (Preceding Calendar Year)	Writeoffs Minus Recoveries (Preceding Calendar Year)	Dividend Rate (Preceding Calendar Year)	Salaries of Officers	Total Loans
2–26	..	10.0	....	..	13.2	73.4	10.0	2.8	8.3	11.3	28.9
8–26	..	18.3	....	..	15.1	79.0	...	....	....	11.3	30.0
1–27	..	12.0	4.2	..	14.8	79.0	12.3	....	8.3	14.2	33.8
9–27	..	5.8	8.3	..	16.6	80.0	....	....	....	14.2	26.4
2–28	..	33.3	5.0	..	17.4	79.0	17.5	3.7	8.3	15.0	29.6
9–28	..	....	....	..	17.1	26.0	....	....	....	15.0	32.0
2–29	..	....	...	..	16.6	27.0	27.7	....	8.3	14.7	34.1
7–29	..	10.0	3.3	..	14.1	27.0	...	....	....	14.7	33.9
1–30	..	20.8	10.0	..	14.9	36.0	23.1	....	8.3	16.7	35.9
10–30	..	16.7	....	..	13.9	46.0	..	....	....	11.1	27.7
4–31	..	16.7	....	..	16.8	46.0	12.9	1.2	5.6	11.3	30.7
12–31	..	18.9	....	..	16.4	46.0	..	....	....	11.3	30.0
4–32	..	9.4	...	..	15.9	46.0	9.3	5.8	2.8	10.2	29.2
11–32	..	12.2	....	..	15.4	46.0	....	....	....	11.3	28.5
5–33	..	11.1	....	..	18.8	41.0	7.4	–.4	8.3	13.3	23.9
3–34	..	8.8	....	..	23.9	44.4	6.8	.8	....	13.4	18.2
8–34	..	10.4	....	..	29.3	69.4	....	....	....	13.4	14.6
1–35	..	11.3	...	..	36.6	69.4	9.1	.2	13.9	13.4	10.7

EXHIBIT 1. *(Continued)*

Part III. Liquidity of Member Bank A

Date of Examination (Month and Year)	As % of Total Deposits													
	Cash Funds	Investments (Not in Default; at Market Value)										Intensity of Liabilities		
	Vault Cash, Reserve with F.R. Bank, Due from Correspondents, Checks and Cash Items	A U.S. Bonds Other Than Those Securing Circulation	B Foreign	C Railroad	D Public Utility	E Industrial	F Municipal and State	G Miscellaneous Tax Certificates, Warrants and Municipal C.I.'s	Total A-G	Good Loans Excluding Slow, Doubtful Loans and Losses	First Mortgages	Time and Savings Deposits	Public Deposits (U.S., State, County and Municipal)	Bankers' Deposits
2-26	27.8	32.2	.3	..	..	..	....	18.3	50.8	28.9	.6	5.7	27.5	1.8
8-26	19.4	41.4	..	..	..	..	3.3	12.1	56.8	29.9	.8	5.0	15.3	.8
1-27	15.4	41.9	.3	..	..	..	3.2	12.0	58.3	33.6	.6	5.1	28.1	1.2
9-27	22.7	36.7	..	..	..	..	8.7	11.7	57.1	26.4	.2	4.6	27.8	1.2
2-28	18.3	31.5	..	..	..	..	8.3	18.8	58.6	29.6	.3	....	36.8	.5
9-28	17.5	39.0	..	..	..	..	8.5	10.0	57.5	32.0	.1	....	33.5	.7
2-29	16.6	42.0	..	..	..	..	9.6	5.0	56.6	34.1	.2	....	37.0	.7
7-29	17.8	42.4	..	..	..	..	9.6	6.3	58.3	33.5	.1	.4	32.0	.6
1-30	17.1	40.7	..	..	..	..	9.5	6.4	56.6	35.9	.1	.5	25.9	1.4
10-30	24.4	43.4	..	..	..	..	9.9	6.5	59.8	27.7	.1	3.4	31.9	1.2
4-31	23.8	23.1	..	.6	..	..	26.2	6.3	56.2	30.1	..	25.4	36.5	.7
12-31	19.8	44.6	..	.6	..	..	8.0	1.6	56.0	30.0	..	24.8	33.5	.7
4-32	26.7	38.9	.6	..	..	..	8.8	4.4	52.7	20.2	..	26.3	33.8	.3
11-32	47.3	20.6	.6	..	..	..	8.3	4.7	34.2	28.5	..	1.9	39.2	.5
5-33	42.6	28.8	.5	..	..	..	6.0	6.1	41.4	23.9	.3	2.0	39.4	.7
3-34	44.3	32.8	..	..	..	..	5.0	5.9	43.7	18.2	.2	12.2	40.2	2.2
8-34	56.8	24.9	..	..	..	..	4.4	4.3	33.6	14.6	.2	11.0	48.3	2.1
1-35	65.9	20.3	..	..	..	..	4.6	3.3	28.2	10.7	.1	12.5	54.9	3.5

EXHIBIT 2

Part I. Degree of Solvency of Member Bank B

Date of Examination (Month and Year)	Capital (In Thousands of Dollars)	Surplus (In Thousands of Dollars)	Total Deposits (In Thousands of Dollars)	Total Loans and Investments (Excl. Circul. Bonds) (In Thousands of Dollars)	As % of Capital and Surplus								
					1. Losses (−)	2. Doubtful Assets (−)	3. Slow Loans and Slow Securities (Foreclosures, Claims, Judgments, Defaulted Bonds, etc.) (−)	4. Banking House, Furniture, and Fixtures (−)	5. "Other Real Estate" (At Book Value) Reported as Slow (−)	6. Estimated Value of "O.R.E." Less Book Value and Less Prior Liens (+ or −)	7. Other Concealed Assets Including Appreciation on Bonds (+)	8. Undivided Profits Plus Reserves for Losses & Depreciation, Less Expenses in Excess of Earnings (+ or −)	9. Solvency Ratio (Net Sum 1–8) (+ or −)
6–26	60	60	989	983	....	9.7	108.3	51.7	13.3	−7.3	..	+ 1.2	−189.1
12–26	60	60	1,016	996	1.0	20.7	126.7	51.7	13.3	+3.3	..	+ 8.3	−201.8
6–27	60	60	1,054	996	1.8	19.9	148.3	51.7	13.3	....	..	− 5.0	−240.0
12–27	60	60	1,011	1,003	2.0	5.7	141.2	52.8	19.2	+3.8	..	.....	−217.1
6–28	60	60	1,068	1,024	2.3	7.9	120.3	52.8	11.2	....	..	− 4.0	−198.5
12–28	60	60	1,036	1,038	3.0	8.7	133.3	53.3	11.7	....	..	+ .8	−209.2
5–29	60	60	1,024	1,020	3.7	11.3	140.0	53.3	....	....	..	+ .8	−207.5
10–29	60	60	1,020	984	.8	18.0	159.6	53.0	11.2	....	..	− 5.3	−247.9
3–30	60	60	968	990	....	24.3	145 0	53.3	11.2	....	..	+ 2.8	−231.0
9–30	60	60	900	924	1.0	24.3	144.3	53.0	15.8	+3.7	..	+ 1.3	−233.4
2–31	60	60	788	852	10.0	31.0	151.8	53.0	9.2	+2.0	..	+ 1.7	−251.3
11–31	60	60	620	742	72.2	38.8	207.5	53.3	9.2	+2.0	..	−12.8	−391.8
6–32	60	60	572	724	86.2	152.3	224.6	53.3	9.2	+2.0	..	− 4.3	−527.9

EXHIBIT 2. *(Continued)*

Part II. Credit Policy and Administration of Member Bank B

Date of Examination (Month and Year)	As % of Capital and Surplus					As % of Capital	As % of Capital and Surplus				As % of Total Deposits
	Total Borrowed Money and Borrowed Bonds	Loans to Directors and Officers (Direct)	Loans Endorsed or Guaranteed by Directors and Officers	Loans to Directors' and Officers' Interests	Deposits per Dollar of Book Capital	Stock Owned by Directors	Net Earnings before Writeoffs and Recoveries (Preceding Calendar Year)	Writeoffs Minus Recoveries (Preceding Calendar Year)	Dividend Rate (Preceding Calendar Year)	Salaries of Officers	Total Loans
6–26	28.3	26.5	8.3	....	16.5	72.3	7.8	...	5.0	7.0	89.7
12–26	8.3	23.3	8.3	....	16.9	73.3	.....	...	...	6.7	83.9
6–27	23.3	23.3	...	15.0	17.6	73.3	8.5	2.8	4.0	7.0	80.5
12–27	10.8	24.2	1.5	20.2	16.9	71.0	....	...	...	9.0	70.4
6–28	21.2	25.7	...	20.2	17.8	53.0	6.8	4.3	4.0	9.0	78.9
12–28	16.7	36.7	...	10.0	17.3	53.3	.....	...	...	12.5	83.4
5–29	16.7	38.3	...	....	17.1	53.3	3.8	6.7	...	11.0	82.2
10–29	33.3	40.0	...	8.5	17.0	53.0	.....	...	...	11.0	84.5
3–30	28.3	41.7	...	4.2	16.1	62.7	1.2	.8	...	11.0	86.4
9–30	33.3	47.7	...	....	15.0	62.7	.....	...	...	11.0	88.2
2–31	52.2	48.7	...	5.0	13.1	62.7	− 3.7	1.7	...	9.0	92.7
11–31	121.0	50.5	5.0	12.5	10.3	62.7	.....	...	...	9.0	108.8
6–32	134.0	56.0	...	5.0	9.5	62.7	−12.8	2.9	...	5.0	116.1

EXHIBIT 2. (*Continued*)
Part III. Liquidity of Member Bank B

Date of Examination (Month and Year)	As % of Total Deposits													
	Cash Funds	Investments (Not in Default; at Market Value)										Intensity of Liabilities		
	Vault Cash, Reserve with F.R. Bank, Due from Correspondents, Checks and Cash Items	A U.S. Bonds Other Than Those Securing Circulation	B Foreign	C Railroad	D Public Utility	E Industrial	F Municipal and State	G Miscellaneous Tax Certificates, Warrants, and Municipal C.I.'s	Total A-G	Good Loans Excluding Slow, Doubtful Loans and Losses	First Mortgages	Time and Savings Deposits	Public Deposits (U.S., State, County, and Municipal)	Bankers' Deposits
6–26	7.5	1.5	1.9	.7	.7	.6	2.3	1.2	8.9	76.0	17.2	76.8	6.4	.9
12–26	13.8	1.6	1.2	...	.4	.2	1.8	1.6	6.8	67.1	16.9	73.6	3.3	1.8
6–27	10.8	1.7	1.5	.4	2.2	1.9	1.7	2.7	12.1	61.9	18.4	73.2	3.4	.8
12–27	10.6	1.9	2.3	.2	1.5	2.1	2.1	2.9	13.0	63.7	18.1	56.1	3.1	1.5
6–28	14.9	2.4	1.6	.2	.9	1.6	1.5	1.9	10.1	64.3	14.7	76.9	5.7	.4
12–28	11.2	1.7	2.0	.2	.9	1.9	1.4	1.7	9.8	66.6	15.8	79.7	1.9	1.3
5–29	11.1	2.5	2.0	.2	.8	1.6	1.2	2.1	10.4	64.5	17.6	78.3	3.3	1.0
10–29	11.4	2.5	1.8	.2	.7	1.6	1.0	1.9	9.7	64.3	16.1	66.8	3.3	.5
3–30	11.8	.6	2.2	.2	1.3	1.7	1.0	1.4	8.4	66.3	19.4	79.1	6.0	...
9–30	11.0	.8	1.0	.4	...	.9	1.1	2.5	6.7	66.4	18.0	80.8	3.5	...
2–31	12.8	.9	.6	...	.2	.4	1.6	1.9	5.6	64.2	18.8	84.4	3.3	...
11–31	7.3	1.1	.3	1.0	.1	.4	1.6	2.2	6.7	49.9	22.0	85.2	7.0	...
6–32	5.5	1.3	.3	.8	...	.4	1.7	1.2	5.7	27.7	26.8	86.2	8.9	...

Estimate the probable degree of accuracy in the figures for assets and proprietorship interest in published statements of condition of banks,[1] and, for contrast, determine a similar factor for general application to corporate balance sheets.

[1] The possibilities of the method herein described in making general surveys are illustrated by the statement of Chairman Leo T. Crowley of the Federal Deposit Insurance Corporation (hereinafter referred to as F.D.I.C.) on April 19, 1935, before a Senate Banking and Currency subcommittee, although the method was not used for the survey to which he referred:

"When the Federal Deposit Insurance Corporation first examined banks applying for membership, it found that there were 732 banks . . . wholly without net sound capital . . .

"In other words, the total of the amounts of the assets which the examiners considered doubtful and loss was equal to or more than the book capital of these banks. There were 723 additional banks . . . which were in the danger class, since the net sound capital in those banks was less than 5 per cent of the deposits . . .

"Through the activities of the corporation, it has been possible to improve the net sound capital through the introduction of local and Reconstruction Finance Corporation funds in over 1,250 of the 1,450 banks which were originally considered to be precariously weak. In place of having $1,550,000,000 of deposits in weak banks, . . . we now have only $310,000,000 of deposits in about 200 weak banks . . .

". . . Upon first examination, the combined net sound capital of nonmember State banks constituted about 45 per cent of the book capital. On our most recent examinations net sound capital constitutes about 70 per cent of the book capital."—*Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Seventy-fourth Congress, first session, on S. 1715*, p. 41.

"The corporation should . . . be given the specific right to require a higher standard than mere solvency for admission . . . "—*Ibid.*, p. 32.

RHODE ISLAND HOSPITAL TRUST COMPANY

FORMATION OF A NEW BANK TO CARRY ON THE COMMERCIAL BUSINESS OF A TRUST COMPANY

The Rhode Island Hospital Trust Company, in common with many financial institutions throughout the United States, watched with interest the progress of banking legislation leading up to the Banking Act of 1933. The trust company was in sympathy with the separation of security affiliates from banks and anticipated a movement toward the separation of trust administration from commercial banking. Consequently, for these and certain other reasons, it decided to separate its own savings and trust departments from its commercial banking department. Early in 1934 a new bank was formed to take over all the commercial business of the trust company.

The trust company, with headquarters in Providence, operated a main office and six branches in Providence, Pawtucket, and Woonsocket. Except that the trust company did not sell securities to customers, it performed every kind of banking and trust service permitted by the laws of Rhode Island and the Federal Reserve Act. At the end of June, 1933, the trust company owned assets totaling $104,502,711, and acted in a fiduciary capacity over properties valued at more than $200,000,000. Savings deposits were $47,126,206;[1] other deposits were $38,453,240; the total amounted to $85,579,446. The trust company was the second largest bank in the state of Rhode Island and was a member of the Federal Reserve System.

The tendency of legislation toward a separation of commercial banking from trust and savings activity met with the approval of the officers of the trust company. They considered such a separation advisable and in the interest of sound banking. Trust business, they believed, fundamentally was not a banking function, and also the problems of the savings department were quite unlike those of the commercial department. In the case of the trust company, the size of the savings and trust departments

[1] There were 28,512 savings accounts with balances under $1,000. The total number of savings accounts was 38,568.

assured a volume of business sufficient to carry costs of administration, and the laws of Rhode Island set up legal safeguards for savings depositors that were sufficient without membership in the Federal Reserve System.[1] A separate commercial bank in the opinion of officers of the bank, would not be limited by state regulations designed to protect savings depositors, and therefore would be better able to adjust its policies to the needs of a national system.

Furthermore, the officers of the trust company believed that participation in the deposit insurance provisions, required of all members of the Federal Reserve System by the Banking Act of 1933, was not necessary for savings deposits in Rhode Island.[2]

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[1] Rhode Island laws require that a guaranty fund be set up in each bank holding savings deposits, to be added to, each year, until it amounts to 5% of such deposits; that all assets securing savings deposits be segregated and approved by the State Banking Department; also that all state banks and trust companies be subject to periodic examination by the bank commissioner. Furthermore, they require the deposit with the state treasurer of state or municipal bonds or first mortgages on real estate in an amount equal to 20% of the entire capital stock of the company, to be held as additional security for the faithful performance of the bank's fiduciary obligations.

[2] For Federal deposit insurance legislation, see *Digest of Rulings of the Board of Governors of the Federal Reserve System from 1914 to October 1, 19[illegible]*, pp. 379–446. There were unimportant amendments in 1938 and 1939.

Assessments for the Temporary Fund in 1933 and 1934 were as follows: On December 15, 1933, ¼ of 1% of deposits of $2,500 or under; on October 1, 1934, ¼ of 1% of deposits between $2,500 and $5,000. Insured banks view these assessments as investments since they are in the form of payments for stock of F.D.I.C.

According to the researches of Arthur R. Tebbutt, presented in an unpublished doctoral thesis in 1935, an assessment of $.4103 per $1,000 of deposits levied upon all national bank deposits in the United States at the beginning of each year from 1865 to 1928, inclusive, would have been sufficient, with collections from stockholders' liability, to pay the total losses to creditors of closed national banks during the same period. This calculated assessment does not include potential earnings upon funds accumulated in anticipation of losses, nor the possible expenses of collecting such assessments and managing such funds. The same study showed similar rates by states, the lowest being: Maine $.0000, Maryland $.0157, Kentucky $.0173, New York $.0466, New Hampshire $.0542, Mississippi $.0619, Missouri $.0731, Connecticut $.0803, Massachusetts $.0887; and the highest being: New Mexico $7.9268, South Dakota $6.8702, Montana $5.8553, Idaho $5.7047, North Dakota $4.7730, Wyoming $4.0343, Arkansas $2.8116, North Carolina $1.8277.

For a statement of the original policy of F.D.I.C. with respect to the appraisal of assets of applicant banks, see Cummings, W. J., "Liquidity Not Sole Rule," The *New York Times*, September 8, 1933, p. 13, col. 4ff. For examples of opinions current in 1933 for and against a guaranty of deposits, see: Association of Reserve City Bankers, A Report of The Commission on Banking Law and Practice, Bulletin No. 3, *The Guaranty of Bank Deposits; The Commercial and Financial Chronicle*, American Bankers Convention Section, September 23, 1933; Crum, W. E., Jr., "The Case for Insured Deposits," *The Burroughs Clearing House*, October, 1933, p. 9ff.

For an excellent survey of the history of state guaranty plans see: Robb, T. B., *The Guaranty of Bank Deposits;* Blocker, J. G., *The Guaranty of State Bank Deposits*, University of Kansas, Business Studies, No. 11. For general discussions, see *Hear-*

Not only had there been few bank closings in that state which had resulted in losses to depositors, but the trust company itself enjoyed a reputation as one of the soundest institutions in New England.

On December 7, 1933, the stockholders of the trust company approved a plan to form a new bank, to be called the Rhode Island Hospital National Bank of Providence. Except for directors' shares, this institution was to be wholly owned by the trust company. It was to take over all the commercial deposits of the trust company, and to receive as assets cash, government bonds, commercial loans and discounts, and secured loans. The trust company was to discontinue its commercial banking business but carry on all its other activities. It was to retire, however, from membership in the Federal Reserve System.

It seemed advisable to open the new bank on the first day of business in 1934. A period of intense activity followed the stockholders' approval of the plan.[1] As a result of the cooperation of government authorities, the new bank received its charter on December 23, 1933, and opened on January 2, 1934, with assets and liabilities as shown in Exhibit 1.

The separation of the national bank from the trust company gave rise to many problems of organization, the most important of which were solved before the opening of the new bank. Continuity of policy was assured after the receipt by the trust company of the Federal Reserve Board's permission to vote its stock of the national bank.[2] Permission also was obtained for directors to serve on the boards of both institutions, and all those who became officers of the national bank continued to hold similar positions in the trust company. The Comptroller of the Currency gave permission for the national bank to establish branches in the same location as the branches of the trust company. Arrange-

ings before the Committee on Banking and Currency, House of Representatives, Seventy-third Congress, second session, on S. 3025; Robb, T. B., "Safeguarding the Depositor," *The Annals of the American Academy of Political and Social Science*, Vol. 171 (January, 1934), pp. 54-62; Emerson, Guy, "Guaranty of Deposits under the Banking Act of 1933," *The Quarterly Journal of Economics*, February, 1934, pp. 229-244.

The Federal Savings and Loan Insurance Corporation has been set up to insure the accounts of building and loan, savings and loan, homestead associations, and cooperative banks. See National Housing Act, Title IV.

See case of Federal Reserve Bank of Minneapolis, final footnote, *supra*.

[1] See case of Randall National Bank, *supra*.

[2] For legislation regulating the voting powers of holding company affiliates of member banks, see *National Bank Act, as amended . . . July 1, 1933*, §233.

ments were made for the new bank to lease the services of many of the operating departments of the trust company.

EXHIBIT 1

Statements of Condition of the Rhode Island Hospital Trust Company and the Rhode Island Hospital National Bank as of the Opening of Business, January 2, 1934

	Rhode Island Hospital Trust Company	Rhode Island Hospital National Bank	Combined
Assets			
Cash and Cash Items	$ 6,303,452	$ 4,685,607	$ 10,989,059
U.S. Government Securities	17,143,319	12,500,000	29,643,319
Loans, Discounts, and Bankers' Acceptances	5,508,478	20,129,383	25,637,861
Customers' Liability on Acceptances and Letters of Credit	....	1,287,124	1,287,124
Bonds	11,447,056	....	11,447,056
Stocks	2,716,973	....	2,716,973
Rhode Island Hospital National Bank Stock	4,960,000	....	....
Rimnik Corporation Stock†	1,441,000	....	1,441,000
Banking Houses	3,500,000	....	3,500,000
Federal Reserve Bank Stock	....	150,000	150,000
Real Estate Mortgages	21,863,607	....	21,863,607
Other Assets	723,813	159,524	883,337
Total Assets	$75,607,698	$38,911,638	$109,559,336
Liabilities			
Demand Deposits	....	$29,269,889	$ 29,269,889
Time Deposits	....	3,301,972	3,301,972
Savings Deposits	$45,948,642	....	45,948,642
U.S. Government Deposits‡	12,392,951	....	12,392,951
Acceptances and Letters of Credit	....	1,287,124	1,287,124
Capital	5,000,000	2,500,000	5,000,000*
Surplus and Undivided Profits	11,838,754	2,500,000	11,878,754*
Other Liabilities	427,351	52,653	480,004
Total Liabilities	$75,607,698	$38,911,638	$109,559,336

* Capital and surplus of Rhode Island Hospital National Bank eliminated and $40,000 added for directors' qualifying shares therein.
† Owns other real estate.
‡ Subscription to recent offering of U.S. Government securities.

Marshal the arguments for and against the segregation of commercial and savings deposits and assets.

Compare the relative advantages of state and national charters for: (*a*) commercial banking functions, and (*b*) trust administration and savings banking functions.

What changes in relations with the F.D.I.C. resulted in this case from the separation into two corporations?

Estimate the probable effects upon deposits in a particular bank of: (*a*) joining the F.D.I.C., and (*b*) leaving the F.D.I.C.

Under what circumstances would banks freely elect to come under an insurance of deposits plan?

What annual premium charge would have been sufficient in the past to cover losses to bank depositors?

Will the same annual premium charge be sufficient to cover losses to bank depositors in the future?

Should premium rates for deposit insurance be uniform for the nation, or varied according to scientific calculations of differences in risk?

What would be the probable total annual cost of determining exact risk rates for individual banks?

Should premium rates be paid by banks or by the insured depositors?

33. QUASI-GOVERNMENT LOANS

UNITED BANK OF AMERICA

SCOPE AND SIGNIFICANCE OF GOVERNMENT LENDING[1]

On December 31, 1934, the United States Government, through the Treasury and numerous government corporations and agencies, was conducting a lending business somewhat like that of a highly departmentalized bank with branches. The funds used were obtained chiefly from the sale of bonds, of which a large portion was short term, having the characteristics of time deposits in a bank.

The significance of this government loan banking may be indicated by combining the assets and liabilities of the Treasury with such credit agencies and corporations, and quasi-government corporations, into an approximate consolidated balance sheet similar to that of an ordinary bank, as shown in Exhibit 1.

On the liability side appear the deposits in the postal savings system and other accounts which are payable on demand. These are followed by the outstanding bonds of all the "departments" of the "government loan bank" arranged in order of maturity. Government paper money in circulation also appears as a liability equivalent to bank notes.

On the asset side are found the combined cash balances of the departments and their loans and discounts, classified by maturity. These items are followed by other tangible assets of the United States for which figures are available. In addition, and merely to balance the statement, the unappraised tangible assets and the unvalued taxing power of the Federal Government are shown in a single item at a nominal value.

Perhaps the last named asset should be entered at its real value. If so, any excess of the estimated real over the stated nominal value would need to be entered also under the liabilities as proprietorship interest and would provide a capital for this hypothetical bank. The taxing power of the Federal Government

[1] For a graphic presentation of the interrelations of the various subsidiary corporations of the Federal Government and a valuable discussion of their activities, see Abbott, C. C., "Federal Corporations and Corporate Agencies," *Harvard Business Review*, Summer, 1938, pp. 436–450.

EXHIBIT 1

Consolidated Statement of Condition of the United Bank of America, as of December 31, 1934*
(000,000 omitted)

Assets		
Cash and Cash Items		
Gold	$ 8,240	
Silver Dollars and Silver Bullion	820	
Other Lawful Money	120	
Deposits with Federal Reserve Banks	150	
Deposits with Other Banks, and Transit Items	2,390	
		$11,720
Loans and Discounts		
Accrued Interest, Etc.	$ 130	
Due in 1935	560	
Due in 1936–1940	1,530	
Due after 1940	6,720	
		8,940
Own Obligations Held		2,050
Investments		
Foreign Obligations	$12,020	
Preferred and Capital Stock of Banks, Railroads, Etc.	840	
Real Estate and Equipment	130	
		12,990
Real Estate for Sale		90
Other Assets		11,820†
Total Assets		$47,610
Liabilities		
Demand Obligations		
Subject to Check	$ 240	
Due to Exchange Stabilization Fund	1,800	
Other	6,070	
		8,110
"Time Deposits"		
Due in 1935 or on Short Notice	$ 6,380	
Due in 1936–1940	9,080	
Due after 1940	21,640	
		37,100
Net Circulation		2,250‡
Other Liabilities		150
Capital		(not stated)†
Total Liabilities		$47,610

* Some of the amounts shown are approximate. All of the amounts have been rounded in tens of millions. Assets and liabilities of the Federal reserve banks and joint stock land banks are not included. Sources: *Daily Statement of the United States Treasury*, December 31, 1934, and January 31, 1935; *Statement of the Public Debt of the United States*, December 31, 1934, and January 31, 1935. Supplementary information was obtained from *Federal Reserve Bulletin*, January, 1935, p. 22, and by correspondence with the Veterans Administration and the Commissioner of Accounts and Deposits, United States Treasury.

† An arbitrary figure, merely enough to balance. The actual figure undoubtedly is larger and the excess would represent "capital."

‡ Does not include contingent liability of $3,202,046,800 for Federal reserve notes in actual circulation in excess of the redemption fund.

is more easily and realistically measured, however, as a source of income to meet the annual burden of interest charges and the maintenance costs of government.

Additional light will be thrown upon the problem of determining the significance of government loan banking by noting the trend of its development relative to that of lending by other, nongovernment forms of banking. Government loans to borrowers in the United States outstanding on June 30, 1929, were well under $2,000,000,000[1] as compared with $8,940,000,000[2] on December 31, 1934. The loans and investments other than United States securities of all privately owned and operating banks in the United States were $51,500,000,000 on June 29, 1929, as compared with $29,300,000,000 on June 30, 1934.

Great care must be exercised in drawing conclusions from these statistical comparisons. The periods do not coincide. Bank loan figures must be adjusted for the effect of numerous bank closings, particularly in 1933. The data are more complete for commercial banking than for investment banking. The year 1929 was one of exceptional business activity. Lastly, bank holdings of United States securities which increased from $7,000,000,000 on June 29, 1929, to $13,200,000,000 on June 30, 1934, should be considered as representing possibly merely a temporary shift of lending volume from private to government units.[3]

The dominance of the government in the investment market, as shown in Exhibit 2, was more pronounced than in commercial banking.

While on December 31, 1934, government loan banking was conducted by a federation of separate institutions, as listed in Exhibit 3, it was reported that a committee of the National

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[1] Estimated at $1,560,000,000, which includes loans of Federal land banks, Federal intermediate credit banks, Department of Agriculture for seed, United States Shipping Board Construction Fund, railroads under postwar laws, and those arising from the sale of surplus war supplies. This total does not include loans of the Federal Reserve System and joint stock land banks, nor certain war emergency loans, nor Treasury holdings of capital stock. Sources: *Annual Report of the Secretary of the Treasury*, 1929, pp. 95, 104, 167, 170; *Second Annual Report of the Farm Credit Administration*, 1934, p. 163; *Annual Report of United States Shipping Board*, 1929, p. 59.

[2] See Exhibit 1 for sources.

[3] Data for total loans and investments of all banks were taken as reported by the Federal Reserve Board. United States security holdings of all banks were computed on the assumption that the fraction of investments consisting of United States securities would be the same for all banks as for all member banks. Sources: *Annual Report of the Federal Reserve Board*, 1933, pp. 160–162, 173; *Federal Reserve Bulletin*, March, 1935, pp. 153, 154.

Emergency Council had been formed to draft recommendations for the consolidation or more complete coordination of the activities of government corporations and credit agencies.

EXHIBIT 2

Public Flotations of New Capital in the United States and Changes in the Debt of Governments and Government Agencies in the United States*
(In millions of dollars)

Year	U.S. Treasury and Governmental Agencies†	New Municipal, State, City, U.S. Possessions, Etc.	Total Governmental	New Domestic Private Flotations	New Foreign Flotations in the U.S.	Total Governmental Domestic, and Foreign
1928	631‡	1,385	754	5,346	1,319	7,419
1929	962‡	1,422	460	8,002	758	9,220
1930	168‡	1,444	1,276	4,483	1,009	6,768
1931	1,829	1,237	3,066	1,550	254	4,870
1932	2,996	764	3,760	325	26	4,111
1933	3,066	485	3,551	161	.....	3,712
1934	4,899	836	5,735	178	.....	5,913

* Sources: For all information except changes in Treasury debt, *Commercial and Financial Chronicle*, January 14, 1933, p. 229, and January 5, 1935, p. 22. Annual changes in the unmatured interest-bearing debt of the United States were computed from the *Statement of the Public Debt of the United States* as of December 31, 1927–1934.

† Although refunding by the Treasury is not included in this column, certain funds obtained by the Treasury were loaned by government agencies (such as the Reconstruction Finance Corporation) for refunding purposes. The remaining data represent new capital, and include no refunding issues.

‡ Decrease.

To what extent has government loan banking taken over the whole field of (*a*) investment banking, and (*b*) commercial banking? Which is a preferable measure for such an estimate: (*a*) the volume of loans outstanding upon a given date, or (*b*) the volume of loans made during a given period?

What has been the trend and what will be the probable trend of government loan banking in the United States?

What contribution, if any, for purposes of analysis, is made by a consolidated statement of Federal assets and liabilities?

EXHIBIT 3

Government Loan Corporations and Credit Agencies of the United States, as of December 31, 1934, with Their Respective Dates of Creation*

LOANS TO AGRICULTURALISTS

Supervision

Farm Credit Administration, 1933

* The figures following the name of each agency show the year of its creation. The classification was made on the basis of type of loan made. Other classifications of interest and value could be made upon the basis of such groupings as the following: (*a*) loans that will surely be repaid as contrasted with those that appear doubtful; (*b*) activities that are self-supporting compared with those that are not; (*c*) the sources of the capital used; (*d*) organizations which will be liquidated after the emergency is over, and those which represent continuing policies; (*e*) agencies that rely on their own credit contrasted with those whose obligations are guaranteed by the United States; (*f*) those organizations that are engaged in extending new loans contrasted with those which are refunding old debts; (*g*) agencies that are directly competitive with private institutions; (*h*) agencies grouped for consolidation into a more integrated organization.

EXHIBIT 3. (*Continued*)

Loans on farm mortgages
Federal Land Banks, 1916
Federal Farm Mortgage Corporation, 1934
Loans by Land Bank Commissioner, 1933
Loans for crop season, etc.
Federal Intermediate Credit Banks, 1923
Production Credit Corporations, 1933
Loans by Governor of Farm Credit Administration, 1934
Loans to promote farm cooperatives
Banks for Cooperatives, 1933
Loans by Governor of Farm Credit Administration, 1931*
Emergency loans
Emergency Crop Production Loan Office, 1918
Agencies being liquidated
Agricultural Marketing Revolving Fund, 1929
Regional Agricultural Credit Corporations, 1932
Agricultural loans not under Farm Credit Administration
Commodity Credit Corporation, 1933
Tennessee Valley Associated Cooperatives, 1934

LOANS TO HOME OWNERS (NOT FARMERS)
Supervision
Federal Home Loan Bank Board, 1932
Loans, etc.
Federal Home Loan Banks, 1932
Home Owners Loan Corporation, 1933
Federal Savings and Loan Associations, 1933
Promotion and development
Federal Housing Administration, 1934
Federal Subsistence Homesteads Corporation, 1933

LOANS TO BUSINESS ENTERPRISES
Reconstruction Finance Corporation, 1932
Federal Reserve Banks, 1913†
First Export-Import Bank, 1934
Second Export-Import Bank, 1934
Electric Home and Farm Authority, 1933
United States Shipping Board, 1916
Interstate Commerce Commission, 1887‡

LOANS TO INDIVIDUALS
Federal Credit Unions, 1934
Veterans Administration, 1930§

LOANS FOR PUBLIC WORKS
Public Works Administration, 1933
Reconstruction Finance Corporation, 1932‖

INSURANCE OF RISKS
Federal Deposit Insurance Corporation, 1933
Federal Savings and Loan Insurance Corporation, 1934
Federal Housing Administration, 1934‖
Participation and Commitments by Federal Reserve Banks and the Reconstruction Finance Corporation, 1934‖

ACCEPTING DEPOSITS
Postal Savings System, 1910

* Until 1933 these loans were made by the Federal Farm Board.
† Industrial loans were authorized in 1934. On December 31, 1934, it could be said that most of the activities of the Federal reserve banks were subject to government management.
‡ Administered loans made under the Transportation Act of 1920.
§ Consolidation of several agencies that dealt with veterans' affairs prior to 1930.
‖ Mentioned above.

SUSQUEHANNA COUNTY NATIONAL BANK

LOANS BY A GOVERNMENT CORPORATION TO ASSIST DISTRESSED BANKS[1]

On December 28, 1932, the Susquehanna County National Bank made application to the Reconstruction Finance Corporation[2] for a third loan to meet withdrawals of deposits.[3] The amount requested was $80,000.

The bank was located in Salamis, New York, a town in an area devoted almost exclusively to the raising of apples; hence, nearly all the loans of the bank were made to apple growers and dealers for the purpose of financing their expenses during the growing

[1] With particular reference to the problems of the Reconstruction Finance Corporation (hereinafter referred to as the R.F.C.) in this case, consult: *R.F.C. Act . . . February, 1935*, especially Sec. 5; *R.F.C. Circulars No. 1* and *No. 4;* Upham and Lamke, *Closed and Distressed Banks*, Ch. XI.

For general accounts of R.F.C. activities, consult: the current *Quarterly Report of Reconstruction Finance Corporotion;* Ebersole, J. F., "One Year of the Reconstruction Finance Corporation," *The Quarterly Journal of Economics*, May, 1933, pp. 464–492; Upham and Lamke, *op. cit.*, Chs. XI–XIII; *Hearings before the Committee on Banking and Currency, House of Representatives, Seventy-second Congress, first session on H. R. 5060 and H. R. 5116; Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Seventy-second Congress, first session, on S. 1.*

[2] Cases obtained from the R.F.C. are typical of certain R.F.C. problems, but do not represent the details of any actual instance.

[3] The R.F.C. established a routine for handling all loans. Most of the applicants were required to conduct their negotiations with the loan agency of their district. Application was made upon a form provided by the loan agency, which required a current financial statement in great detail, past statements for comparison, complete information about each item offered as collateral, authorization to consult bank examiners and other government agencies about the applicant, and the corporate resolutions necessary for the borrowing. After 1934, an agreement concerning the amount of salaries paid also was required.

When a loan application was received, it was assigned to the examining division of the agency. An agency examiner prepared an analysis which concluded with his recommendation as to the loan. This was discussed at the next meeting of the advisory board of the agency. The analysis and the original application then were transmitted to Washington with the advisory board's comment "recommending" or "rejecting." After the staff at Washington reviewed the analysis, the board of directors either "approved" or "rejected," and advised the loan agency by wire. The applicant was then notified of the decision.

If the loan was approved, the applicant delivered a signed note and collateral to the agency, and the loan was disbursed through the Federal reserve bank of the district, which acted as custodian and agent for the R.F.C.

Usually, a period of two to three weeks elapsed before final action was taken on an application; but in emergencies, applications had been received and funds disbursed within one day.

and selling season. In normal years the loans were paid after the shipment of the apples in the fall; in years when prices were insufficient to cover the cost of growing the crop, the bank found it necessary to extend the maturity of many loans until the next season's crop had been shipped. In making renewals, the bank usually required sufficient security in the form of real estate mortgages to cover the loan and any new advances made during the second year. Borrowers had been found to be very reliable and little difficulty had been experienced in eventually obtaining full payment.

Since apple prices in New York State had been below the cost of production in both of the crop years 1931 and 1932, banks in the apple growing districts had found it very difficult to obtain payment on loans in 1932. At the same time depositors were drawing upon their deposit accounts for living expenses. In the case of the Susquehanna County National Bank, deposits had fallen more than 20% during 1932, as shown in Exhibit 1.

EXHIBIT 1

Statements of Condition of the Susquehanna County National Bank, as Published, 1931 and 1932
(000 omitted)

	December 31, 1931	June 30, 1932	December 28, 1932
Assets			
Cash	$ 149	$ 148	$ 104
Loans and Discounts	2,109	2,062	2,059
Bonds and Stocks	441	422	389
Banking House	114	114	116
Other Real Estate Owned	5	19	25
Collections and Other Assets	16	5	13
	$2,834	$2,770	$2,706
Liabilities			
Deposits	$1,901	$1,751	$1,470
Bills Payable	618	798	1,023
Circulation	15	15	16
Capital	125	125	125
Surplus	125	31	31
Undivided Profits	50	50	41
	$2,834	$2,770	$2,706

The bank's problem of meeting withdrawals was aggravated by the condition of its bond portfolio. Book values were greatly

in excess of market prices in 1932. If values had been booked at current prices a serious impairment of capital would have been shown and the bank would have been forced to close unless new capital could have been obtained within three months. Bank examiners had been lenient in this respect, but they required the bank to take all losses when bonds were sold. Consequently the directors were very reluctant to meet withdrawals by the sale of bonds.

EXHIBIT 2

Description of Collateral Held by R.F.C. on December 28, 1932, for Loans Outstanding to the Susquehanna County National Bank

Loan Made September 10, 1932

Authorized amount $125,000, outstanding December 28, $125,000. Collateraled by 8 unsecured notes and 19 first mortgages on real estate, classified as follows:

Unsecured Notes	Face Amount	Loan Value
6 notes—Grade 1	$20,625	$15,469 (75%)
2 notes—Grade 2	15,886	9,532 (60%)
	$36,511	$25,001 (68%)

Five notes in Grade 1 are church notes and the other note is of a maker with a financial statement indicating considerable strength. Notes in Grade 2 are of makers with financial strength but liquidation may be slow.

Mortgages	Face Amount	Loan Value
9 good	$ 56,810	$42,606 (75%)
9 fair	69,750	41,850 (60%)
1 doubtful	7,500	3,750 (50%)
	$134,060	$88,206 (66%)

Thirteen of the above mortgages with a face value totaling $111,059 are in arrears in interest payments to the extent of $5,668. Period of delinquency ranges from six to eighteen months.

Loan Made December 12, 1932

Authorized amount $17,500, outstanding December 28, $17,500. Loan is secured by 13 first mortgages on real estate, classified as follows:

Mortgages	Face Amount	Loan Value
6 good	$13,000	$ 9,750 (75%)
5 fair	19,735	11,841 (60%)
2 doubtful	22,375	11,188 (50%)
	$55,110	$32,779 (59%)

The amount advanced to the bank was influenced by its urgent need for funds. No directors' guaranty was required for either loan.

Before turning to the R.F.C. for help in September, 1932, the bank had borrowed all that its New York correspondent would lend on the collateral offered, and had rediscounted at the Federal reserve bank almost all the eligible paper held. A substantial amount of collateral in excess of the face value of the rediscounts

EXHIBIT 3

Details of Financial Condition of the Susquehanna County National Bank, as of December 28, 1932

	Book Value		Amount Pledged	Amount Free
Assets				
Cash Items				
Cash and Due from Banks	$ 103,776			
Drafts in Process of Collection	12,739			
		$ 116,515	....	$ 116,515
Loans and Discounts Secured by:				
U.S. Government Bonds	$ 250		$ 250	....
Other Securities not Real Estate	54,539		26,454	28,085
Mortgages, on Farm Property	360,180		189,170	338,570
Mortgages, on Other Property	167,560			
Other Loans:				
To Banks	6,260		....	6,260
To Others	1,469,837		830,936	638,901
		2,058,626		
Bonds and Stocks				
U.S. Government Bonds	$ 15,625		15,625	....
Miscellaneous Bonds	146,633		146,633	....
Foreign Bonds	219,570		214,366	5,204
Stock in Federal Reserve Bank	7,500		7,500	....
		389,328		
Banking House		116,394	....	116,394
Other Real Estate Owned		24,675	....	24,675
Total Assets		$2,705,538	$1,430,934	$1,274,604
Liabilities				
Deposits				
Demand Certificates	$ 112,003			
Demand Checking	173,515			
Savings	1,184,288			
		$1,469,806		
Bills Payable:				
To Federal Reserve Bank	$ 794,425			
To Hamilton Trust Company (New York)	85,938			
To R.F.C.	142,500			
		1,022,863		
Circulation		15,625		
Capital		125,000		
Surplus		31,250		
Undivided Profits		40,994		
		$2,705,538		

EXHIBIT 3. (*Continued*)

Notes on Statement Items

Loans and Discounts		
Slow and Doubtful Paper		
Slow	$1,045,602	
Doubtful	122,804	
Loss	16,219	
		$1,184,625
Real Estate Loans*		
Taken for Debt	$ 631,813	
Secured by Real Estate Direct	211,745	
Assigned Mortgages	172,140	
		1,015,698
Excessive Loans		24,063
Book Value of Loans in Default of Principal or Interest		582,175
Eligible Paper, Not under Rediscount		37,000
Bonds and Stocks, Market under Book Value		173,373
Interest on Savings Accounts, 4% Payable January 1 and July 1		
Bills Payable:		
To Federal Reserve Bank		794,425
Secured by: Eligible Paper	$ 794,425	
Collateral Notes	26,704	
Miscellaneous Bonds	60,185	
Foreign Bonds	119,031	
Stock	7,500†	
	$1,007,845	
To Hamilton Trust Company		85,938
Secured by: Miscellaneous Bonds	$ 86,448	
Foreign Bonds	95,335	
	$ 181,783	
To Reconstruction Finance Corporation		142,500
Secured by: Unsecured Notes	$ 36,511	
Notes Secured by Real Estate and Mortgages	189,170	
	$ 225,681	

Earnings Record (in thousands of dollars)	1930	1931	1932
Net Earnings before Charge-offs	36	18	6(d)
Charge-offs (Net of Recoveries)	23	11	94
Dividends	10	8	3

* Includes collateral.
† Not hypothecated but subject to a prior lien in case of insolvency of Susquehanna County National Bank.
(d) Deficit.

had been required by the Federal reserve bank, upon the ground that most of the eligible paper was based upon a single hazard, the shipment of apples.

The bank had borrowed $125,000 from the R.F.C. in September, 1932, and an additional $17,500 on December 12, upon collateral as detailed in Exhibit 2.

In applying for the additional advance of $80,000, the bank submitted a current statement, shown in Exhibit 3, and wrote in part as follows:

> A large part of the apple crop still in the county is under crop mortgage to outside parties and with present prices and rate of sale our deposits are bound to decrease during the month of January and collections on loans and discounts will not be large.
>
> Owing to unsatisfactory financial statements of makers or endorsers, the Federal reserve bank has deemed it advisable to charge back to us or refuse rediscount to more than $62,000 worth of paper in the last three months and from financial statements now being furnished we expect that amount will be increased. We do not have eligible paper to substitute at present and as most of our collections from loans come on eligible paper we shall be unable to maintain the required reserve with the Federal reserve bank without the additional advance requested.

The collateral offered to secure the proposed loan was a first mortgage for $80,000 maturing June 29, 1933, drawn in favor of the R.F.C. The mortgage covered the bank building and lot, and the adjoining property. The bank building was a three-story brick structure; the adjoining building was a converted stable which was not fireproof. Only a small portion of the buildings was unrented. Rentals in 1932, not including payments by the bank, totaled $7,562. For 1933 it was expected that income equal to that of 1932 would be maintained. Expenses would be $3,750 and taxes $2,190.

Estimates of the current value of the properties varied widely. The book value was $141,069 in 1932, but an examiner's report made in the fall stated that depreciation charges had not been adequate. An appraiser recommended by a neighboring Federal land bank reported a valuation of $134,750; the properties were assessed for tax purposes at $37,500. The agency examiner of the R.F.C. valued the property as follows: bank building, $50,000; business building, $8,000; land, $22,000; total, $80,000. He stated that his evaluation was low owing to the current depression of all values, and allowance for the fact that the bank building was a "one-purpose" structure.

Appraise the adequacy of the security offered with the $80,000 loan application.

Waiving considerations of liquidity, would this $80,000 loan be a satisfactory risk for: (*a*) city correspondent bank, or (*b*) Federal reserve bank?

What additional considerations enter into the appraisal of the loan by the R.F.C. as compared with a city correspondent bank?

Should the R.F.C. make this loan if there is any doubt as to the probability that the bank will remain open?

Should the R.F.C. make all bank loans offered when such loans are necessary to meet withdrawals of deposits and to keep the applicant banks open?

Was the Susquehanna County National Bank solvent on December 7, 1932? When is a bank insolvent?

TIMBERLAKE NATIONAL BANK

SALE OF PREFERRED STOCK TO A GOVERNMENT CORPORATION IN ORDER TO STRENGTHEN THE CAPITAL STRUCTURE OF A SOLVENT BANK[1]

After making an examination of the Timberlake National Bank in October, 1933, the chief national bank examiner of the district notified the local loan agency of the R.F.C. that he had recommended that the bank strengthen its capital structure by authorizing and selling $125,000 of preferred stock. His report has been summarized in Exhibit 1. The recommendation was made in accordance with the desire of the F.D.I.C. and other government agencies that banks should have capital, surplus, and undivided profits amounting to at least 10% of unsecured deposits. The examination of the bank showed that it was solvent, but the amount of its aggregate capital funds remaining after the charge-offs recommended in the examiner's report, as shown in Exhibit 2, was less than the standard.[2] An increase of capital stock amounting to $125,000 would be sufficient to provide the desired protection for depositors.

The bank was one of three commercial banks in a Wisconsin city of 30,000 inhabitants. The bank enjoyed a good reputation among business men in its district, and its management was considered capable by the supervisory authorities.

Soon after the R.F.C. Loan Agency received the chief examiner's recommendation, the president and several directors of the bank came to the agency and expressed the opinion that the

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[1] See: Jones, J. H., "Preferred Stock for Banks," *The Commercial and Financial Chronicle*, American Bankers Convention Section, September 23, 1933, pp. 19–20; *Annual Report of the F.D.I.C.*, 1934, pp. 50–54.

For legislation authorizing issue of preferred stock of national banks, etc., and its purchase by the R.F.C., see *National Bank Act, as amended . . . July 1, 1933*, §§229–232. For regulations of the R.F.C. regarding preferred stock of banks, see *R.F.C. Circulars No. 6*, and *No. 18*.

[2] For an excellent survey of examiners' policy in appraising bond holdings of banks, see *Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Seventy-first Congress, third session, on S. Res. 71*, pp. 1069–1082. The recommendations of bank examiners have gained greater authority from the Banking Act of 1933 by the provisions for removal of officers and directors who persist in "unsafe and unsound practices." See *National Bank Act, as amended . . . July 1, 1933*, §238.

examination had been too severe, and that the powers given to the preferred stockholders were onerous. With respect to the severity of the examination, they pointed out that about 85% of the amount recommended for charge-offs consisted of a reduction to market value of bonds not rated "good grade" by the examiner. In previous examinations book values higher than market had not been criticized in the case of bonds whose intrinsic worth was greater than the market price. The new procedure appeared

EXHIBIT 1

Selected Data from Examiner's Report of Condition of the Timberlake National Bank, as of October 3, 1933
(000 omitted)

	Statement Prior to Examination October 3, 1933	Examiner's Classification of Assets				
		Liquid	Slow	Doubtful	Loss	Depreciation
Resources						
Cash and Due from Banks	$ 371	$ 371	....	...	..	....
United States Securities	930	930	....	...	..	....
Other Marketable Securities	1,826	1,539	....	...	..	$287†
Loans and Discounts*	2,786	2,032	$713	$40	$1	....
Stock of Federal Reserve Bank	11	......	11	...	..	....
Banking House	138	......	138	...	..	....
Other Real Estate	14	.....	14	...	..	....
Redemption Fund	6	6	....	...	..	....
Total Resources	$6,082	$4,878	$876	$40	$1	$287
Liabilities						
Capital	$ 125					
Surplus and Undivided Profits	480					
Circulation	125					
Rediscounts	25					
Deposits—Secured‡	332					
Commercial Deposits	824					
Savings Deposits	4,171					
Total Liabilities	$6,082					
Ratio of Capital Funds to Unsecured Deposits	12.11%					
Ratio of Cash and U. S. Securities Unpledged to Unsecured Deposits	23.24%					

* Amount owed by directors: personally, $169,000; as endorser, $96,000. Amount collateraled: $165,000. Amount owed unsecured by firms in which directors are interested: $63,000.

† Depreciation of good grade bonds $77,000, of other bonds $209,000; in default $1,000.

‡ Postal savings, county, and municipal deposits, secured by market value of U.S. securities, $140,000; by other marketable securities, $189,000.

unreasonable, since an increase in market values was expected as trade recovery progressed, and there was no reason to expect that the bank would sell its bonds before a rise in prices took place. Application of the former policy to the recent examination would show that the bank's deposits were amply protected by the existing capital, surplus, and undivided profits.

EXHIBIT 2

Examiner's Recommendation of Changes in Resources and Liabilities of the Timberlake National Bank
(000 omitted)

	Statement Prior to Examination October 3, 1933	Additions Recommended	Eliminations Recommended	Resulting Pro Forma Statement
Resources				
Cash and Due from Banks......	$ 371	$100	....	$ 471
United States Securities........	930	....	....	930
Other Marketable Securities....	1,826	....	$210	1,616
Loans and Discounts...........	2,786	....	41	2,745
Stock of Federal Reserve Bank..	11	....	....	11
Banking House................	138	....	....	138
Other Real Estate.............	14	....	....	14
Redemption Fund.............	6	....	....	6
Total Resources.............	$6,082	$100	$251	$5,931
Liabilities				
Capital—Preferred............	......	$125	....	$ 125
Capital—Common.............	$ 125	....	....	125
Surplus and Undivided Profits...	480	....	$251	229
Circulation....................	125	....	....	125
Rediscounts..................	25	....	25	......
Deposits—Secured............	332	....	....	332
Commercial Deposits..........	824	....	....	824
Savings Deposits.............	4,171	....	....	4,171
Total Liabilities.............	$6,082	$125	$276	$5,931
Ratio of Capital Funds to Unsecured Deposits..............	7.09%*	....	....	9.59%
Ratio of Cash and U.S. Securities Unpledged to Unsecured Deposits.....................	23.24%	....	....	25.25%

* After eliminations recommended.

In response to these arguments, officials of the R.F.C. pointed out that experience had shown that the maintenance of a strong capital position in each bank was necessary for the welfare of the

EXHIBIT 3

Summary of Parts of Proposed Articles of Association of the Timberlake National Bank[1]

The proposed Articles provided with respect to the disposition of earnings that "net profits" or "net loss" should be calculated semiannually by "deducting from the gross earnings from all sources . . .

(A) All expenses for such period;

(B) All interest accrued during such period;

(C) All losses determined during such period, and such charge-offs and write-downs of assets and transfers to reserves (whether from income, undivided profits or surplus) for such period (including all charge-offs, write-downs, and transfers to reserves requested by the Comptroller of the Currency for such period) as may be reasonably necessary to make proper provision for doubtful assets, depreciation, and undetermined losses, but to the extent only that such losses, determined or undetermined, charge-offs, and write-downs of assets exceed reserves previously set up therefor in such period or any prior period;

(D) Provision for all taxes for such period, including taxes measured by income and taxes based on the ownership of stock in the Association paid or payable by the Association for the account of its shareholders, without prejudice to such right as the Association may have to recover the same;

(E) Such transfers for such period to surplus as may be required by law; and

(F) The net loss, if any, determined in accordance with the provisions of this section 5, accrued since the Organization Date, accumulated to and existing at the beginning of such period.

All recoveries over net book value on assets previously charged off or written down or against which reserves have been set up, and all transfers from reserves to surplus or undivided profits (other than transfers made to reflect recoveries already treated as gross earnings), shall be considered gross earnings for the respective periods during which such recoveries or transfers are effected."

The Articles further provided that as long as any preferred stock was outstanding, the net profits "for the six months' period ending on the next preceding December 31 or June 30, as the case may be," should be applied "in the following order of priority:

1. To the payment of dividends on the outstanding preferred stock accrued to such February 1 or August 1, as the case may be; and

2. To the payment into the preferred stock retirement fund . . . of a sum equal to forty per cent of the remainder, if any, of such net profits: *Provided, however*, That the aggregate amount paid into the preferred stock retirement fund in any one year need not exceed five per cent of the maximum aggregate par value of the preferred stock at any time outstanding, whether or not any such stock shall have been subsequently retired or the aggregate par value thereof reduced in any manner whatsoever: *Provided further, however*, That, unless otherwise elected, from time to time, by the Association by action of its Board of Directors, it shall not be required to make such payment into the preferred stock retirement fund except from such net profits as may have accrued from and after December 31, 1935.

Any balance of net profits for any such period may be applied from time to time to such lawful purposes as may be determined by the Board of Directors, subject, however, to . . . [the following paragraph].

Limitations on retirement of stock.—Except with the approval of the Comptroller of the Currency no preferred stock shall be called or purchased for retirement by the Association unless the then unimpaired capital, surplus, and undivided profits of the Association, and the retirement funds provided for herein (after giving effect to the issuance of any stock issued to provide

[1] Prepared from R.F.C. form P.S.–1 (12–4–33). For comparative purposes, see the form of Articles of Association in *Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks*, pp. 8–10.

EXHIBIT 3. (*Continued*)

funds for such retirement) exceed $480,000[1] by an amount at least equal to the sum necessary to effect such retirement. No shares of preferred stock shall be called or purchased for retirement unless all accrued dividends (whether or not earned or declared) to the dividend payment date next preceding the date of such retirement shall have been paid on all shares of preferred stock at the time outstanding."

Other parts of the proposed Articles gave the owners of preferred stock equal voting rights with common stockholders until two or more semiannual dividends were in arrears, when preferred stockholders became entitled to twice the number of votes to which the common stockholders were entitled.[2]

As long as the R.F.C. held not less than 25% of the preferred stock outstanding, if:

"(A) The Association shall be in arrears in the payment of as many as two semiannual dividend payments (whether or not consecutive and whether or not earned or declared) on the preferred stock (exclusive of any such dividend which may be payable at any time within three (3) months from the date of issuance of the preferred stock); or

(B) The amounts paid into the preferred stock retirement fund . . . on and after February 1, 1937, shall not have amounted in the aggregate to five per cent of the maximum par value of the preferred stock at any time outstanding (whether or not any such stock shall have been subsequently retired or the aggregate par value thereof reduced in any manner whatsoever) multiplied by the number of calendar years which shall have elapsed since January 1, 1936; or

(C) The fair value of the assets of the Association, as determined by the Comptroller of the Currency, shall be less than an amount equal to all of its liabilities, including all capital stock outstanding; or

(D) The Association shall violate or fail to observe any of the terms, provisions, or conditions of its Articles of Association—

then after written notice from the R.F.C. of the existence of any of said conditions and so long as any of said conditions in A, B, C, and D above shall continue:

1. All directors, officers, and employees of the Association shall receive compensation at rates not exceeding such maximum limitations as may be fixed by the vote of the holders of a majority of the shares of preferred stock at the time outstanding.

2. In case the R.F.C., with the approval of the Comptroller of the Currency, at any time shall notify the Association that any director, officer, or employee of the Association is regarded by the R.F.C. as unsatisfactory, and in case such director, officer, or employee is not removed from office (and, if requested by the R.F.C., replaced with a director, officer, or employee satisfactory to it) within thirty days after receipt by the Association of such notice, then, and until such removal and replacement shall have been effected, the holders of preferred stock at the time outstanding shall be entitled, as a class, to vote on all matters twice the number of the votes to which the holders of common stock, as a class, are at the time entitled, and each holder of preferred stock shall be entitled to a pro rata share of the votes to which his class is entitled.

3. The Association shall not directly or indirectly purchase or otherwise acquire any real estate for its own use, or lease any real estate for its own use for a term longer than one year, without in each case the affirmative vote of the holders of a majority of the preferred stock at the time outstanding, or a written waiver of voting rights in respect thereto by the holders of such majority: *Provided, however*, That this limitation shall not apply to real estate acquired [in making or collecting mortgage or other loans] . . ."

Finally, the new Articles provided that a meeting of shareholders could be called by the holders of at least 10% of the stock of any class.

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[1] Amount set for the Timberlake National Bank.

[2] For legislation granting right of cumulative voting to stockholders of national banks, see *National Bank Act, as amended . . . July 1, 1933*, § 233. The provisions of this section apply also to state chartered member banks affiliated with a holding company. See *Federal Reserve Act, as amended . . . July 1, 1933*, Sec. 9, p. 24.

banking system as a whole. They explained that it was the settled policy of the R.F.C. to purchase the preferred stock of those banks which needed new capital, but that the stock could be retired as rapidly as earnings and recoveries from charge-offs made funds available. If the retirement were completed within three years, the R.F.C. would rebate one-fifth of the dividends received on the stock, making the effective dividend rate 4% per annum.[1] The officials of the R.F.C. also indicated that a part of the loans classified as "slow" might be found to be "doubtful" at another examination, and to that extent new capital would be needed despite any rise in the market values of bonds.

The representatives of the bank then stated that the revision of the bank's Articles of Association to the form required by the R.F.C. gave disproportionate powers to the preferred stockholders. The disputed portions of the articles have been summarized in Exhibit 3.

The officials of the R.F.C. assured the representatives of the bank that there was no intention of using the powers of preferred stockholders for any purpose except to prevent mismanagement. Certain instances of R.F.C. control, they believed, had received undue publicity, since no action was contemplated in most cases. They pointed out, furthermore, that many of the rights of the preferred stockholders became effective only if earnings were insufficient to cover the preferred dividends and the retirement fund. From the record of the bank, shown in Exhibit 4, it was clearly evident to them that there was little danger of inadequate earnings, although it was quite possible that common stock dividends at predepression rates could not be paid until after the retirement of the preferred stock.

The R.F.C. officials urged the bank strongly not to miss the opportunity to strengthen its position, for in their opinion banks

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[1] In a letter to the chairman of the R.F.C., the President of the United States approved the plan of a rebate, and stated definitely that the administration had no intention of exercising active control over banks through preferred stock owned by the R.F.C. See *Commercial and Financial Chronicle*, October 7, 1933, p. 2563.

In a bulletin dated November 21, 1934, the R.F.C. instructed its loan agencies to inform banks whose preferred stock was held that dividends at the following rates would be accepted in lieu of the rate set out in their Articles of Association:

- 5% per annum for dividends to and including March 31, 1934;
- 4% per annum for dividends from April 1, 1934, to and including January 1, 1935;
- 3½% per annum for dividends from January 2, 1935, to and including January 31, 1940;
- 4% per annum thereafter.

with insufficient capital funds soon would find that all government supervisory agencies were agreed that their capital position must be improved.

EXHIBIT 4

Earnings and Dividends of the Timberlake National Bank for the Years Ending December 31, 1929, to 1933
(In thousands of dollars)

	Earnings before Charge-offs and Recoveries	Earnings after Charge-offs and Recoveries	Dividends Paid
1929	61	58	12.5
1930	59	20	12.5
1931	68	28	12.5
1932	94	4	12.5
1933*	68	10	6.3
Average	70	24	11.2

* Last three months estimated; does not include charge-offs after October 1, 1933.

Is this bank insolvent? Is it threatened with insolvency?

Outline the principles or reasoning upon which a sound decision must be based when fixing the standard for the maximum ratio of deposits to capital for a particular bank upon any given date.

Does the 10:1 "rule of thumb" appear to be appropriate for application in this case?

Assuming that the ratio of capital to deposits ought to be increased in this case, what alternatives might be used in preference to a sale of preferred stock to the R.F.C.?

If the bank issues this preferred stock, what would be the effect on the prospect for common dividends, assuming the net rate of profit to be the same as in the last five years?

How many years will be required to redeem this preferred stock, if issued?

What penalties and reprisals, if any, might follow from a refusal to issue the preferred stock as suggested?

Appraise the risk of government (R.F.C.) dominance or meddling in the affairs of this bank after the issuance of the preferred stock.

If the R.F.C. is prepared to strengthen the capital structure of solvent banks before insolvency, how can the F.D.I.C. incur any losses upon its insurance of bank deposits?

YATES TRUST COMPANY

REFINANCING FARM MORTGAGE INDEBTEDNESS THROUGH A GOVERNMENT CORPORATION

In January, 1935, the mortgage department of the Yates Trust Company in Cedar Rapids, Iowa, was considering the advisability of accepting $5,800 in 3% bonds of the Federal Farm Mortgage Corporation, at par, in settlement of a debt of $6,367.50 owed by Mr. Rhodes, a retired farmer living in Dubuque, Iowa. The indebtedness was made up of a first mortgage on farm land amounting to $6,000, and interest, accrued at 5¼% since November 1, 1933. The mortgage had matured on November 1, 1934.

For a number of years before 1932 the trust company had followed the policy of investing a portion of its trust funds in first mortgages on Iowa real estate, chiefly farm property. Before the rapid decline in land values that accompanied the depression of the 1930's, such loans had been considered excellent media for the investment of funds which did not require convertibility into cash at short notice. The mortgage department of the trust company had made loans only on first mortgages, and had never advanced on new loans over 50% of the appraised value of the property exclusive of its buildings, although the latter always were included in the mortgage. The trust company's appraisers based their evaluation chiefly on the prices set by recent sales of near-by properties, but they also made reports on the condition of the farm, and the character of the borrower.

The sharp decline in land values that accompanied the depression caused the trust company to cease making new loans, and to adopt a more lenient policy of handling delinquencies and renewals. Renewals were granted if a new appraisal showed that the debt was covered by a reasonable margin, and foreclosure proceedings were not brought against a delinquent unless it appeared that he would not be able to carry on without excessive borrowing, or could not make payments promptly after prices of farm products returned to normal. In many of the cases where foreclosure had been deemed advisable, the trust company had "bid in" the property, assuming the equivalent of the debt, because other

buyers were not to be found. In such instances the company endeavored to rent the property until it could be sold.[1]

The loan to Mr. Rhodes had been made November 5, 1924, on the security of 120 acres in Winneshiek County, Iowa. The original advance of $8,000 was reduced to $6,000 by payments in 1925 and 1926. At the time the loan was made, the property had been appraised at $20,000, or about $165 per acre. This valuation was in accord with contemporary sales of neighboring farm land, although it was lower than values of land in other counties of Iowa where the soil was more productive. The farm buildings were valued at $2,800. In the appraiser's report the statement was made that sales of corn and other crops would provide funds for taxes and interest payments, with a substantial margin. Investigation in November, 1924, showed that Mr. Rhodes was not indebted to any other lenders except in small amounts for purchases which had recently been made. His general reputation was good.

The mortgage which was made in 1924 matured in 1929, at which time it was extended for five years as a matter of routine, after a reappraisal had valued the land at $19,800 and the buildings at $2,600. The interest rate was changed from 5% to 5¼%, in accord with the general level of interest rates in Iowa in 1929. Interest payments were made regularly until November 1, 1933. The payment then due was not made until December of the same year. No payments were received after that time.

Mr. Rhodes had rented his farm in 1930, and had moved to Dubuque, where he was living with his son. In November, 1934, he reported that he owned no other assets, that his tenant was unable to pay more than enough rent to meet taxes as they came due, and that he himself was heavily in debt to other lenders. There was a second mortgage on the farm for $2,500, and loans amounting to $3,200 from four local banks were overdue. A certain portion of the bank loans was secured by a chattel mortgage; the remainder was unsecured. Mr. Rhodes was unable to provide funds to pay any of his indebtedness except through new loans.

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[1] Emergency laws passed in Iowa in 1933 and 1934 provided for continuance until March 1, 1935, of any foreclosure proceedings brought on mortgages executed before January 31, 1934. The laws also provided for the rental of the property, and required that the owner in possession should be given preference. Provision was made for prompt foreclosure if cause were shown.

See *Laws 45th G. A.*, Ch. 182, and *Laws 45th G. A. (extraordinary session)*, Ch. 137.

An appraiser of the trust company reported in November, 1934, that the real estate market in Winneshiek County was very inactive, but that a near-by farm had recently been sold at $75 per acre. It was estimated that the Rhodes farm would be able easily to earn taxes and interest on the first mortgage if current prices held up.

In December, 1934, Mr. Rhodes applied for a refunding loan from the local national farm mortgage association, through which Federal land bank and land bank commissioner loans were disbursed. After a land bank appraiser had examined the property, the land bank offered to lend a total of $7,000 on a first and a second mortgage provided that a settlement could be made between Mr. Rhodes and his creditors so that the only claims against him would be held by the land bank.[1] Since 5% of the proposed loan would have to be used to purchase stock in the local national farm loan association, $6,650 would be available for disbursement to the present creditors. This sum would be paid, except for amounts less than $100, in the form of Federal Farm Mortgage Corporation 3% bonds of 1949.[2] The bonds were fully guaranteed by the United States as to both principal and interest.

After learning the details of the land bank offer, Mr. Rhodes in January, 1935, asked the trust company to accept $5,800 in bonds as a settlement of its claim. He hoped to be able to persuade his other creditors to settle for the $850 that would remain.

By 1935, legislation had greatly restricted the freedom of mortgage holders to bring foreclosure actions on farm property.

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[1] The trust company did not know the amount of the valuation made by the land bank appraiser, but it observed that part of the proposed advance was to be secured by a second mortgage loan made by the Land Bank Commissioner. Since first mortgage land bank loans could be made up to 50% of the value of the land, plus 20% of the value of permanent improvements, the trust company calculated that the valuation of the land was less than $13,200, or $110 per acre. (It was assumed that the buildings were valued at $2,000.) In accordance with existing law, the land bank appraiser had based his evaluation principally on the "normal value" of the land, using the average prices of farm commodities for the five-year period 1909–1914.

The first and second mortgages offered by the land bank and the commissioner bore interest at 5%, and an amortization plan running from 20 to 30 years was required. However, amortization payments were not to begin until 1938, and the interest on the first mortgage would be 4½% until the same year.

[2] Closing price on January 15, 1935, 100⅝₂. The Federal Farm Mortgage Corporation issued its bonds to the land banks and the Land Bank Commissioner in exchange for the bonds of the land banks and the mortgages received by the Land Bank Commissioner. The corporation was created by *73d Cong. Sess. II*, Ch. 7.

With particular reference to this case, the trust company reviewed the provisions of the Frazier-Lemke Act, passed on June 28, 1934, which provided among other things for a five-year delay in proceedings against the debtor, and prevented the levying of deficiency judgments.[1] The constitutionality of this act had not been established, in January, 1935, when conflicting decisions of United States courts were before the Supreme Court of the United States for adjudication.[2] There had been no decision in the judicial district that included Winneshiek County. Iowa farmers had been reluctant to invoke the provisions of the law because of the injurious effect of such action upon their credit standing with merchants and others.

Compare the methods of appraisal used by the trust company and the land banks.

Was the trust company's policy regarding renewals fair to both borrower and lender?

Should the trust company accept the compromise offer? If not, on what terms should it offer to settle?

Under what circumstances would it be more profitable for the bank to retain the delinquent mortgage?

Should this trust company hold or sell these bonds when and if received in settlement?

Did the policy of farm mortgage[3] relief sponsored by the Government tend to stimulate recovery? Did it have other social advantages?

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[1] *73d Cong. Sess. II*, Ch. 869. See also *72d Cong. Sess. II*, Ch. 204, Sec. 75.

[2] The act was later held by the Supreme Court to be unconstitutional.

[3] Home mortgages in distress were handled by the Home Owners Loan Corporation. The operations did not differ materially in fact or in principle from those illustrated herein for the Federal Farm Mortgage Corporation.

TONAWANDA NATIONAL BANK

EFFECT OF PRICE-FIXING UPON BANKING RISKS

During the summer of 1934 the Tonawanda National Bank of Memphis, Tennessee, approved for the crop year 1934–1935 a secured credit line of $100,000 for Walters, Helmer, and Company, cotton brokers. In October the company requested a more liberal basis of evaluation of the cotton which the company would pledge as security. It asked the bank to lend 10.8 cents per pound, 90% of 12 cents, on cotton of the same grade as had been required by the bank in the past. The Commodity Credit Corporation had announced its willingness to lend growers 12 cents a pound on the same grade of cotton.

In requesting the change in margin requirements, the treasurer of the company argued that the comprehensive plan of control which was being enforced by the Agricultural Adjustment Administration gave assurance that the price of cotton could not fall under 10.8 cents per pound during the 1934–1935 season. He emphasized the fact that the plan differed from the unsuccessful operations of the Cotton Stabilization Corporation because it was based upon control of the amount to be produced and provided support to the market through the loans of the Commodity Credit Corporation.[1] A similar plan to the one for 1934–1935 had operated to increase prices in 1933–1934, as shown in Exhibit 1, and success for the 1934–1935 plan seemed assured.

For a number of years the bank had extended to the company a secured credit line of $100,000. It had been required that the

[1] The stated objective of the cotton control plan was to increase the purchasing power of producers, chiefly by means of price increases, until it was equivalent to that of the period August, 1909–July, 1914. In October, 1934, the "parity" price was above 12 cents per pound for low middling seven-eighths staple cotton. For the principal legislation relating to the cotton control plan, see the *Agricultural Adjustment Act, 73d Cong. Sess. I*, Ch. 25; and *73d Cong. Sess. II*, Ch. 157. A brief summary of the workings of the plan in 1933–1934 will be found in Richards, H.I., *Cotton under the Agricultural Adjustment Act.*

The Commodity Credit Corporation, with power to lend on or buy agricultural commodities, was created by Executive Order on October 16, 1933. It confined its operations to corn and cotton. Loans were made to producers under certain conditions, including the borrower's agreement to sign a cotton reduction contract. Loans were made without recourse against the borrower, in case the collateral proved insufficient to satisfy the debt.

security consist of cotton in bonded warehouse, low middling or better in grade, seven-eighths inch or better in staple, and hedged in the market for cotton futures unless it had been sold for future delivery at a fixed price. Loans had been made on such security up to 90% of current market value, and the company had been required to supply additional collateral whenever declining spot prices caused an impairment of the required margin.

EXHIBIT 1

Tonawanda National Bank

Cotton Prices*

(Unit: cents per pound, middling, seven-eighths inch; average spot price at 10 American markets)

Month	1929	1930	1931	1932	1933	1934
January	18.88	16.56	9.37	6.15	6.01	10.91
February	18.86	15.11	10.12	6.40	5.85	12.02
March	19.78	14.74	10.15	6.44	6.19	12.09
April	18.95	15.40	9.50	5.83	6.84	11.66
May	18.23	15.12	8.70	5.41	8.49	11.28
June	18.36	13.21	8.42	4.99	9.28	12.04
July	18.29	12.21	8.66	5.54	10.52	12.58
August	18.04	11.14	6.57	7.08	9.24	13.12
September	18.01	10.15	5.83	7.40	9.19	12.85
October	17.62	9.82	5.75	6.37	9.16	12.40
November	16.75	10.09	5.95	6.03	9.65	.....
December	16.64	9.16	5.78	5.72	9.87	.....

* Source: United States Department of Agriculture, *Yearbook of Agriculture, 1934*, p. 466, *Crops and Markets*, 1934, *passim*.

The company, though small, had obtained an excellent clientele, chiefly among southern mills. It had been conservatively operated, and was in a very strong financial position. The company's deposit account had been profitable, the collateral given for loans had been maintained satisfactorily, and the officers of the company were held in high regard.

Appraise the effect of government price-fixing upon banking risks.

To what extent do and should banks rely upon forecasts of market prices of commodities?

ERIE ELECTRIC COMPANY

FEDERAL RESERVE BANK PARTICIPATION IN ADVANCES TO PROVIDE WORKING CAPITAL[1]

The receiver for Erie Electric Company, a manufacturing concern in a midwestern city of 35,000 inhabitants, applied in October, 1934, to the Federal reserve bank of its district for a commitment covering a five-year "working capital loan" of $40,000 contingent upon the termination of the receivership. A local bank had agreed to make the advance, provided the Federal reserve bank gave its commitment to rediscount or purchase the outstanding amount of the advance, subject to the local bank's guaranty of 20%, at any time during its life.[2] If the advance were made, the company would be able to give employment to 100 additional men, thus doubling its payroll.

More than 90% of the company's sales in the past three years had arisen from the manufacture of an electrical indicator for motor trucks, which showed the direction of turns. This device was required by the laws of several states, and an increasing market was expected. The company also manufactured ammeters, ignition coils, generator cut-outs, switches, horn buttons, and other small electrical equipment for automobiles. None of the products had been used as original equipment on automobiles or trucks since 1922. Sales were made to jobbers through manufacturers' agents. The company had over 5,000 accounts. Units of sale were very small, and over 99% of sales were on credit.

[1] For legislation granting power to the Federal reserve banks and the R.F.C. to make loans for industrial purposes when credit is not available through the usual sources, see *73d Cong. Sess. II*, Ch. 653, approved June 19, 1934. For regulations under this law, see: *Federal Reserve Bulletin*, July, 1934, pp. 489–492 (Regulation S); *R.F.C. Circulars No. 13* (revised) and *No. 15* (revised); and *Federal Reserve Bulletin*, November, 1934, pp. 752–755. Consult Hardy and Viner, *Report on the Availability of Bank Credit . . .* , passim.

[2] The reserve bank had established a charge of 1% per annum for commitments to discount or purchase industrial advances, and commonly named 3½% as the rate of discount. It was the policy of the reserve banks to obtain participation by financial institutions in every case, unless exceptional circumstances existed. The reserve banks were authorized to participate in advances and to make commitments to rediscount or purchase loans. This authorization was restricted by the provision that any financial institution to which participation was extended must agree to accept at least 20% of any loss that might be suffered as a result of an advance.

EXHIBIT 1

Condensed Financial Statements of the Erie Electric Company and Predecessors, as of December 31, 1925 to 1933, and July 31, 1934*
(000 omitted)

	1925	1926	1927	1928†	1929	1930	1931	1932†	1933†	July 31, 1934†
Assets										
Cash	$ 28	$ 18	$ 2	$ 2	$ 11	$ 5	$ 3	$ 2	$ 2	$ 1
Accounts Receivable, Net	157	182	51	50	55	25	30	38	16	17
Inventories	332	374	165	108	138	198	160	120	122	121
Current Assets	$ 517	$ 574	$ 218	$160	$204	$ 228	$ 193	$160	$140	$139
Land and Buildings	250	255	163	159	128	311	307	303	303	303
Machinery and Equipment	695	690	435	421	282	427	427	405	410	406
Patents	24	24	24	24	199	218	224	81	80	80
Deferred Charges	10	38	32	11	7	5	4	2	2	2
Total Assets	$1,496	$1,581	$ 872	$775	$820	$1,189	$1,155	$951	$935	$930
Liabilities										
Notes Payable	$ 232	$ 273	$ 22	$ 83	.....	$ 117	$ 20	$ 0	$ 7	$ 2
Accounts Payable	33	161	80	107	$ 14	24	14	18	2	9
Accrued Items	28	37	22	27	7	18	31	9	16	11
Current Liabilities	$ 293	$ 471	$ 124	$217	$ 21	$ 150	$ 65	$ 36	$ 25	$ 22
Taxes Deferred	....	35	32	....	....	60	42	....	....	12
Due to Affiliate	....	....	....	....	....	67	179	....	....	....
Estate Liabilities	....	....	....	....	....	....	....	298	298	298
Total Debt	$ 293	$ 506	$ 156	$217	$ 21	$ 286	$ 286	$334	$323	$332
Reserve for Depreciation	319	361	314	449	7	30	54	346	346	346
Preferred Stock	431	431	431	431	....	....	....	....	....	....
Common Stock	251	250	250	250	493	541	541	564	560	560
Surplus	202	33	279(d)	572(d)	209	332	274	293(d)	294(d)	308(d)
Total Liabilities	$1,496	$1,581	$ 872	$775	$820	$1,189	$1,155	$951	$935	$930
Net Sales	$1,114	$1,261	$1,150	$402	$415	$ 435	$ 298	$160	$122	$ 51§
Gross Profit	205	131	7(d)	44	87	54	53	40	39	10§
Operating Income‡	131(d)	98(d)	234(d)	60(d)	44(d)	316(d)	61(d)	26(d)	2(d)	14§(d)
Other Income	18	42	25	26	2	7	6	1	1	1§
Profit on Sale of Assets	88(d)	83(d)	103(d)	213(d)	....	....	....	....	....	....
Net Income	201(d)	139(d)	312(d)	256(d)	42(d)	309(d)	55(d)	25(d)	1(d)	13§(d)
Dividends	30	30	....	....	....	....	....	....	....	....

* Not audited. Statements sworn to by treasurer.
† Company in equity receivership.
‡ After depreciation and taxes.
§ Seven months.
(d) Deficit.

The company had not made a profit in any year since 1922. A change in the management at that time had resulted in the defection of the salesmen, and the loss of several contracts covering the manufacture of original equipment for automobiles. The company underwent an equity receivership in the years 1928 and 1929, one of the results of which was the transfer of control of the company to a holding company owned by members of a wealthy family. One of the younger members of the family, who had demonstrated his ability as a business executive, was made president of the Erie Electric Company. Despite reductions in costs, operations continued to be unprofitable, as shown in Exhibit 1. Large loans from the holding company were obtained in 1930, 1931, and 1932. The holding company declined further support in the fall of 1932, and the company went into a second equity receivership. The court named the president of the company as receiver.

By October, 1934, a plan of reorganization had been approved by a large proportion of the creditors of the company. The operation of the plan, however, was contingent upon the obtaining of $40,000 in new money and a definite settlement of claims for unpaid taxes. It was anticipated that the consent of the city, to which the taxes were owed, could be obtained to a settlement which would cancel accrued interest, and fund $24,000 of the back taxes into five-year notes, without interest, maturing in equal amounts each six months.

Certain offsets to the estate liabilities[1] were expected. The receiver, who had obtained a judgment claim against the holding company for $280,000 in an action based upon his personal advances to it, was willing to assign his claim to the Erie Electric Company in return for the company's note covering his expenses in obtaining the judgment. The claim could be used to offset the sum of $241,696 that was due to the affiliate, but the excess would have no value, as the holding company was insolvent.

In the application to the Federal reserve bank, the receiver submitted a statement as of July 31, 1934, together with a schedule showing the effects of the proposed reorganization, as shown in Exhibits 2 and 3. The schedule showed that, in addition to the settlement of the estate liabilities and deferred taxes, reductions

[1] The term "estate liabilities" refers to the liabilities of the company on the date it went into receivership.

were to be made in the stated value of certain assets. The reduction in accounts receivable brought the stated value more in line with the company's experience from July to October. Of the $19,376 accounts due July 31, 1934, about $7,200 remained uncollected in the middle of October. The reductions in the valuation of inventories covered losses that might be realized from the unsalability of the finished goods, owing to obsolescence.

The local bank which had agreed to the proposed loan had great confidence in the ability of the president of the company to rebuild its sales volume as soon as the receivership was lifted. The direction indicator sold well in those states whose laws

EXHIBIT 2

Detailed Financial Statement of the Erie Electric Company, in Receivership, as of July 31, 1934, with Schedule Showing Effect of Proposed Reorganization

	Statement July 31, 1934*		Proposed Changes: Increases	Proposed Changes: Reductions	Pro Forma Statement
Assets					
Cash		$ 1,197	$ 15,348		$ 16,545
Accounts Receivable†					
Due in less than 31 days	$ 9,455				
Past Due less than 6 months	3,685				
Past Due more than 6 months	6,236				
Deduct Reserve	*2,642*				
		16,734		$ 8,000	8,734
Inventories					
Raw Materials	$ 16,081				
Goods in Process	46,002				
Finished Goods	118,578				
Deduct Reserve for Obsolescence	*68,574*				
Manufacturing Supplies	7,170				
Jobbing Goods	1,914				
		121,171		37,558	83,613
Current Assets		$139,102			$108,892
Land‡	$ 19,704				
Buildings‡	283,192				
		302,896			302,896
Machinery and Equipment					
Machinery and Furniture†.	$263,841				
Dies, Jigs, and Tools‡	142,462				
		406,303			406,303
Patents					
Cost	$225,061				
Deduct Reserve	*144,539*				
		80,522		60,400	20,122
Deferred Charges		1,741			1,741
Total Assets		$930,564	$ 15,348	$105,958	$839,954

* Not audited. Statement sworn to by treasurer.
† Sales almost entirely on credit. Terms: 2% 10 days, net 30.
‡ Reproduction value, November 15, 1930, adjusted for purchases and sales to date.

EXHIBIT 2. (*Continued*)

		Statement July 31, 1934*	Proposed Changes		Pro Forma Statement
			Increases	Reductions	
Liabilities					
Receiver's Notes Payable		$ 1,440			$ 1,440
Accounts Payable		8,826			8,826
Accrued Items					
Current Taxes	$ 7,833				
Payroll	111				
Receiver's Advances	2,576				
Commissions	822				
		11,342			11,342
Current Liabilities		$ 21,608			$ 21,608
Deferred Taxes		12,263		$ 12,263	
Estate Liabilities					
Customers' Credit Balances	$ 342			342	
Due to Affiliate	241,696			241,696	
Commissions in Dispute	3,513			3,513	
Accounts Payable	5,174			5,174	
Notes Payable	4,000				4,000
Taxes Past Due	34,846			10,846	24,000
Interest Accrued on Taxes	8,600			8,600	
		298,171			
Notes Payable, Industrial Advance			$ 40,000		40,000
Notes Payable, Costs of Litigation			20,000		20,000
Total Debt		$332,042			$109,608
Reserve for Depreciation					
Land	$ 3,616				
Buildings	123,048				
Machinery and Furniture	148,707				
Dies, Jigs, and Tools	70,960				
		346,331	36,286		382,617
Common Stock		560,000		344,000	216,000
Surplus					
As of July 21, 1932	$297,810(d)				
Receiver's Deficit	9,999(d)				
		307,809(d)	439,538		131,729
Total Liabilities		$930,564	$535,824	$626,434	$839,954

* Not audited. Statement sworn to by treasurer.
(d) Deficit.

required its use, and a trend toward similar requirements was noted in other states. It was planned to regain a foothold in the original equipment market through the influence of certain automobile executives who were close friends of the receiver. Furthermore, the company was developing a market for a new device using flashlight batteries that made it easy to start automobiles in cold weather. It was expected that this product could be sold in substantial numbers. These factors brought a conclusion that the company probably could double its sales volume within a year. Such an increase in sales would be necessary for the resumption of profitable operations.

EXHIBIT 3

Details of Disposition of Estate Liabilities and Deferred Taxes under Proposed Plan of Reorganization of the Erie Electric Company

	Pay in Cash	Convert to Five-year Serial Notes without Interest	Offset	Cancel
Deferred Taxes...........	$12,263	....	....	....
Customers' Credit Balances.	342	....	....	....
Due to Affiliate...........	....	....	$241,696*	....
Commissions in Dispute....	1,200	....	....	$ 2,313
Accounts Payable..........	....	....	....	5,174
Notes Payable............	....	$ 4,000	....	....
Taxes Past Due...........	10,846	24,000	....	....
Interest Accrued on Taxes..	....	....	....	8,600
Total..................	$24,651	$28,000	$241,696	$16,087

* The creation of this offset involves acceptance by the new company of a liability of $20,000 to cover costs of litigation.

Bank credit had not been available to the company since 1930. During the summer of 1934 the local loan agency of the R.F.C. had rejected an application for a $40,000 five-year loan.

The properties of the company were unencumbered except for tax liens, and it was proposed that the $40,000 advance be secured by a first mortgage on the land and buildings, as well as by a chattel mortgage on all machinery, equipment, and furniture.[1] The loan would be repaid in equal annual installments of $10,000, beginning in January, 1937.

In connection with its investigation of the proposed loan, the Industrial Advisory Committee received a report prepared by a credit investigator of one of the largest banks in the district, which had provided a member of its staff for the committee's use. His conclusions were that the obligations of the reorganized company could not be met without a doubling of sales volume, that there was no reasonable prospect of doubling sales, and that the value of the properties offered as collateral would be small in case of liquidation. He recommended that the application be rejected.

The Industrial Advisory Committee nevertheless voted to recommend approval of the proposed commitment, subject to the

[1] Tax liens take precedence over the rights of mortgagees.

lifting of the receivership, the deferment of taxes, and adequate security for the loan.

The application next came before a committee of officers of the Federal reserve bank, which had final authority in the matter. The committee agreed that the value of the collateral offered was sufficient to cover the proposed advance and the tax liens that would be outstanding after the reorganization. The commitment was approved, subject to the lifting of the receivership, and the execution of the necessary legal minutiae.

In what respects should a banker's analysis for an intermediate-term working capital industrial loan differ from the analysis for a short-term "commercial" loan?

To what extent should any particular bank make: (*a*) "working capital" loans, and (*b*) "permanent" working capital loans?

Accepting the findings in the Hardy-Viner survey as typical, why did banks reject applications for working capital loans?

Under what circumstances would a prospective industrial borrower use a Federal reserve bank rather than his own bank?

Why should any bank ask the Federal reserve banks to take over a good industrial loan? Should the Federal reserve banks take any but good industrial loans?

Should the Federal reserve banks require the participation of interested banks in every industrial loan made?

Upon what grounds, if any, should the United States Government, through the Federal reserve banks or otherwise, encourage the continuance of deficit companies in any industry? Does not such encouragement to continuance prolong, if not assure, permanent deficits and endless increases in uncollectible loans?

In what respects do intermediate-term working capital loans to industrial concerns present a different problem to: (*a*) commercial banks, (*b*) Federal reserve banks, and (*c*) the R.F.C.?[1]

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[1] For an excellent statement of the credit analysis methods and bases of judgment used by the R.F.C., see Glover, J. D., "Industrial Loan Policy of the RFC," *Harvard Business Review*, Summer, 1939, pp. 465–476.

34. FEDERAL RESERVE CREDIT POLICY

LAURENCE NATIONAL BANK

CREDIT POLICY OF THE FEDERAL RESERVE SYSTEM[1]

At a regular meeting of the board of directors of the Laurence National Bank of New York City, held May 8, 1931, one of the directors stated that he was disturbed considerably by an item in the morning newspaper which related that the Federal Reserve

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[1] References on the history and purposes of Federal Reserve System policy: *Hearings before the Committee on Banking and Currency, House of Representatives, Sixty-ninth Congress, first session, on H. R. 7895*, especially pp. 633–734, 791–806, 833–907 (Statement of A. C. Miller), pp. 290–379, 464–477 (Statement of Benjamin Strong), pp. 907–935, 964–1022 (Statement of W. R. Burgess), pp. 581–604 (Statement of Carl Snyder), pp. 735–790 (Statement of W. W. Stewart); *Hearings before the Committee on Banking and Currency, House of Representatives, Seventieth Congress, first session, on H. R. 11806; Annual Report of the Federal Reserve Board*, 1923, pp. 10–36; *The Commercial and Financial Chronicle* (Editorials), Vol. 132, pp. 3019–3021 (April 25, 1931), pp. 3393–3395 (May 9, 1931); *Federal Reserve Bulletin*, March, 1929, pp. 177–178 (Definition of banking policy versus credit policy), February, 1929, p. 94 (Letter of February 2, 1929, to reserve banks); Sprague, O. M. W., "Brokers' Loans Dangerous—Reserve Banks Largely Responsible for Inflation," *The Annalist*, April 20, 1928, p. 687, "The Banking Position and its Prospects: Control Lies with Reserve Banks," *ibid.*, July 20, 1928, pp. 87–88; *Hearings before the Committee on Banking and Currency, House of Representatives, Seventy-fourth Congress, first session, on H. R. 5357*, especially pp. 179–430 (Statement of M. S. Eccles), pp. 431–463 (Statement of E. A. Goldenweiser); *Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Seventy-fourth Congress, first session, on S. 1715*, especially pp. 12–16 (Title II of proposed "Banking Act of 1935"), pp. 279–325 (Statement of M. S. Eccles), pp. 675–733, 743–776 (Statement of A. C. Miller).

See also: Beckhart, Smith, and Brown, *The New York Money Market*, Vol. IV; Burgess, W. R., *The Reserve Banks and the Money Market*, revised edition; Clark, L. E., *Central Banking under the Federal Reserve System;* Fisher, Irving, *The Stock Market Crash—And After*, pp. 188–191, 233–237; Hardy, C. O., *Credit Policies of the Federal Reserve System;* Harris, S. E., *Twenty Years of Federal Reserve Policy;* Reed, H. L., *Federal Reserve Policy*, 1921–1930; Riefler, W. W., *Money Rates and Money Markets in the United States;* Willis, H. P., *The Federal Reserve System*, Chs. XLI, LIX, LX.

See also: Dowrie, G. W., *American Monetary and Banking Policies*, Chs. VI, IX; Dunkman, W. E., *Qualitative Credit Control*, Chs. V–VII; Edie, L. D., *Dollars;* Goldenweiser, E. A., *Federal Reserve System in Operation*, Chs. IV, V, XV; Hawtrey, R. G., *The Art of Central Banking*, Ch. II; Keynes, J. M., *A Treatise on Money*, Vol. I, pp. 200–209, Vol. II, Chs. 31–33, 37; Laughlin, J. L., *A New Exposition of Money, Credit and Prices*, Vol. II, Ch. XV; Robertson, D. H., *Banking Policy and the Price Level*, revised edition; Secrist, Howard, *Banking Standards under the Federal Reserve System;* Slichter, S. H., *Towards Stability*, Ch. III; Spahr, W. E., *The Federal Reserve System and the Control of Credit;* Warburg, P. M., *The Federal Reserve System: Its Origin and Growth*, Vol. I, Ch. VII, and pp. 488–517.

For data on Federal reserve credit outstanding and money market and business conditions, see Appendices II, III, and V, *infra*.

Bank of New York had reduced its rediscount rate, effective Friday, May 8, to 1½%, a record low. This director queried the president of the bank as to the probable effect of this rate reduction upon the Laurence National Bank, particularly as to the need for changes in portfolio policy and as to the results in terms of short-run and long-run earnings.

Another director thereupon suggested that he desired a statement of the reasons actuating the Federal Reserve Board and Federal reserve banks in their discount rate policy and open-market operations. He also asked if anyone could forecast the time and direction of such Federal reserve actions, and, if so, upon what evidence.

The president stated that the complexity of the problem was such that some time would be required to prepare a comprehensive report, and suggested that an informal directors' meeting be held for the purpose of receiving and discussing such a report.

Assuming that the president asked the economist of the bank to prepare the report, what should the economist include therein?

As to the philosophy or theory underlying Federal reserve system credit policy:

(*a*) What definite statements are available in:

1. The Federal Reserve Act;
2. The publications of the Federal Reserve Board;
3. The published statements of persons, now or formerly members of the Federal Reserve Board or connected with Federal reserve banks?

(*b*) What conclusions may be drawn from observation of statistical data for the period from January, 1918, to date?

(*c*) Has the policy been, and should it have been, consistent throughout the period?

Does the Federal Reserve System fix interest rates in the United States?

Does the credit policy of the Federal Reserve System increase or decrease the long-run average earnings of banks in the United States?

NIAGARA NATIONAL BANK

EFFECT OF CENTRAL BANK POLICY UPON THE INVESTMENT OF SURPLUS FUNDS

During 1932, the Niagara National Bank of Cleveland had been confronted continuously with the problem of the profitable handling of surplus funds. On October 13 the New York Stock Exchange call loan renewal rate fell from 2% to 1%, and other money market rates also declined.[1]

The bank had been maintaining larger primary and secondary reserves than previously, in order to be prepared for possible sudden withdrawals of deposits or rapid expansion of loans to correspondent banks, as evidenced by Exhibit 1. For many

EXHIBIT 1

Condensed Statement of Condition of the Niagara National Bank, as of October 1, 1932

(000,000 omitted)

Resources		Liabilities	
Cash and Due from Banks	$ 48	Capital	$ 4
U.S. Government Securities	13	Surplus	13
Acceptances and Open-market Paper	3	Undivided Profits	1
Municipal and Short-term Bonds	7	Contingency Reserve	3
Other Investments	13	Taxes and Other Payables	2
Demand Collateral Loans	30	Deposits	111
Time Collateral Loans	8		
Unsecured Loans	8		
Building	2		
Other Assets	2		
Total Resources	$134	Total Liabilities	$134

years funds not needed for reserves, loans, or investments had been placed for ready availability in short-term government securities, acceptances of other banks, brokers' loans, and commercial paper. On October 14, 1932, the chairman of the board

[1] The term "money market" usually refers to the market for investment media which are considered generally to be most sound and liquid. Such media are: brokers' loans; bankers' acceptances; commercial paper; high-grade short-term United States Government, municipal, and corporate bonds. See Beckhart, B. H., and others, *The New York Money Market*, especially Vols. II and III.

Tables of money market rates will be found in Appendix III. In October, 1932, out-of-town banks paid New York correspondents a commission of ½% per annum for placing call loans.

of directors of the bank named a committee of officers to recommend advisable changes in policy, if any, with respect to the placing of surplus funds.

The committee agreed at its first meeting that surplus funds probably would be available in large amounts for some time to come, and that further reductions in money market rates were likely. The Federal reserve banks had pursued a policy of large-scale open-market purchases after the passage of the Glass-Steagall Act in February, 1932, and had maintained their portfolios at the high levels reached on August 10. Imports of gold from abroad and other factors had contributed to the reduction of rediscounts at the Federal reserve banks and the increase in the excess reserves of member banks.[1] Although there were evidences of some revival in business activity, it was clear that large demands for short-term commercial credits would not soon be forthcoming.[2]

In the discussion that followed the description of the general situation, certain members of the committee argued that the time had come for the bank to liberalize its credit and investment requirements. It was pointed out that the easy money policy of the Federal reserve banks was designed to bring about an expansion of credit, which would result in increased prices and in better business. The bank's loaning officers had been declining many applications for credit which, although repayment was assured, might be outstanding more than a year, or might involve a resort to illiquid collateral. Similarly, the investment department had declined to purchase long-term bonds of the highest grade, as it was not certain that declines in market value had ceased.

The advocates of a change in policy believed that the existing policies had outworn their usefulness. Specifically, they suggested that the loaning officers be instructed to approve meritorious applications for loans to be repaid within three years, and that the bond portfolio be expanded to include, for permanent holding, long-term high-grade corporation issues the market value of which was lower than it would be after recovery was well under way.

[1] Tables of reserve bank credit and factors in changes will be found in Appendix V. The *Federal Reserve Bulletin* for October, 1932, showed excess reserves of member banks as of August, 1932, on a daily average basis, as $270,000,000, an increase of $169,000,000 in one year.

[2] For a contemporary summary of business conditions in the Cleveland district, see Federal Reserve Bank of Cleveland, *Monthly Business Review*, October 1, 1932.

Other members of the committee who did not agree that the situation warranted so great a change in policy felt that the bank could increase its earnings by trading in the money market for profits on declining interest rates. This policy would involve the purchase of longer-term assets such as United States Government bonds and the sale of such assets at a time when a decline in interest rates had increased their market values.

The remaining members of the committee felt that the only safe procedure was to continue the existing policy despite falling rates and difficulties in placing all the funds available. The uncertainties in banking, the business world, and politics were emphasized, and it was pointed out in addition that any new form of investment would involve the acquisition of assets similar to those that had caused the ruin of so many banks. The bank was experiencing difficulties in collecting past due loans that were not self-liquidating, and new loans might well bring about similar difficulties later on. The suggestion that the bank endeavor to reap trading profits in the management of its liquid investments was believed to be dangerous because it would introduce an element of speculation into the most conservatively invested funds in the bank's possession.

35. MONEY MANAGEMENT

BANK OF MANEUVER

FEDERAL TREASURY MONETARY AND CREDIT OPERATIONS[1]

During the years 1933 and 1934, the United States Government adopted extraordinary monetary measures for the alleged purpose of stimulating business recovery. Gold was devalued. Federal expenditures were increased. The Federal deficit was financed largely by banks. Bank deposits were expanded. Excess reserves were created in enormous volume. Interest rates on high-grade securities, obligations of the United States Government, and other types of loans were depressed persistently and to extraordinarily low levels. These developments created new and difficult problems for bank managers.[2]

The problem confronting bank managers can best be illustrated by reference to a particular date. The situation on August 15, 1936, did not vary much from bank to bank. All banks had excess reserves, large holdings of Federal securities, and few requests for loans from their customers.

The problem of determining bank policy under such conditions was made even more difficult by the inevitable uncertainty

[1] For timely discussions of United States monetary management, see: Seltzer, L. H., "The Problem of Our Excessive Banking Reserves," *Journal of the American Statistical Association*, Vol. 35 (March, 1940), pp. 24–36; Johnson, G. G., Jr., *The Treasury and Monetary Policy*, 1933–1938; Currie, Lauchlin, *The Supply and Control of Money in the United States*, second edition, especially Chs. IV, V, VIII, XI, XIII–XVI; Anderson, B. M., Jr., *A Critical Analysis of the Book by Lauchlin Currie . . .* ; Currie, Lauchlin, "A Reply to Dr. B. M. Anderson, Jr.," *Quarterly Journal of Economics*, XLIX (August, 1935), pp. 694–703; Dunkman, W. E., *Qualitative Credit Control*, Chs. V–VII; Smith, D. T., *Deficits and Depressions;* Hansen, A. H., *Full Recovery or Stagnation?;* Slichter, S. H., *Towards Stability*.

For general surveys of the money problem, see: Cole, G. D. H., ed., *What Everybody Wants to Know about Money*, Ch. VIII; Foster and Catchings, *Profits*, Part V; Great Britain, Committee on Finance and Commerce, *Report* (June, 1931), Part I, Ch. XI, Part II, Chs. I–III; Hawtrey, R. G., *Trade Depression and the Way Out*, new edition; Hayek, F. A., *Prices and Production*, second edition; Wernette, J. P., *Money, Business and Prices*, Chs. V–VI.

Consult the references contained in the case of Laurence National Bank, *supra;* Sprague, O. M. W., "Easy Money Due to Saved Capital, Not Bank Credit: Heavy Gold Export Safe," *The Annalist*, January 13, 1928, pp. 42–43.

[2] For concise summaries of these developments in 1934, see: Ebersole, J. F., "The Mechanism and Possibilities of Inflation," *The Review of Economic Statistics*, Vol. XVII (February 15, 1935), pp. 45–48; *Federal Reserve Bulletin*, March, 1935, pp. 141–144. For extracts thereof, see Ebersole, J. F., *Bank Management—A Case Book*, second edition, pp. 468–472.

prevailing as to the next moves which the United States Government might make. The only announcement which had been made as to the rules that would be observed in the government's attempt to manage the volume of money and credit was that discretion and opportunism would be deciding factors from day to day.

The power of the Treasury to control as if it were a central bank resides in its ability to expand or contract bank deposits and reserves at will. Proximately this power is based in part upon its command of adequate holdings of specie, which may be transferred to the Federal reserve banks, and of deposits, which may be shifted between Federal reserve and other banks or withdrawn from banks. The form and extent of these holdings, as of August 15, 1936, are shown in Exhibit 1. The changes which have taken place in these holdings since January, 1934, are shown in Exhibit 2.

An explanation of Treasury money management powers follows.

The increase of the reserve requirements for member banks of the Federal Reserve System by 50%, effective after the close of business on August 15, 1936, marks another important experimental step on the road of money management. To the initiated, there is no mystery as to the way in which bank reserves control may contribute to the objectives sought by the advocates of money management.

Money management is but a part of the larger problem of social organization for the modification or control of fluctuations in economic activity. Money management, itself, is a complex of numerous measures or devices, thought to contribute to the major objective, of which

EXHIBIT 1

Treasury Current Assets and Liabilities, as of August 15, 1936*

(000,000 omitted)

Gold

Assets		Liabilities	
Gold	$10,664.9	Gold Certificates:	
		Outstanding (outside of Treasury)	$ 2,914.9
		Gold Certificate Fund—Federal Reserve Board	5,430.0
		Redemption Fund—Federal Reserve Notes	13.1
		Gold Reserve	156.0
		Exchange Stabilization Fund	1,800.0
		Gold in General Fund	351.3
Total	$10,664.9	Total	$10,664.9

EXHIBIT 1. (*Continued*)

Silver

Assets		Liabilities	
Silver	$ 727.0	Silver Certificates Outstanding	$ 1,163.4
Silver Dollars	508.0	Treasury Notes of 1890 Outstanding	1.2
		Silver in General Fund	70.5
Total	$ 1,235.0	Total	$ 1,235.0

General Fund

Assets		Liabilities	
Gold (see above)	$ 351.3	Treasurer's Checks Outstanding	$ 22.7
Silver (see above)	70.5	Deposits of Government Officers:	
United States Notes	2.5	Post Office Department	5.5
Federal Reserve Notes	15.0	Board of Trustees, Postal Savings System:	
Federal Reserve Bank Notes	.6	5% Reserve Lawful Money	60.8
National Bank Notes	2.1	Other Deposits	66.8
Subsidiary Silver Coin	5.6	Postmasters, Clerks of Courts, Disbursing Officers, Etc.	125.2
Minor Coin	2.3	Deposits for:	
Silver Bullion (Cost Value)	332.2	Redemption of National-bank notes (5% Fund, Lawful Money)	.6
Silver Bullion (Recoinage Value)	.1	Uncollected Items, Exchanges, Etc.	5.8
Unclassified—Collections, Etc.	2.6		$ 287.4
Deposits in:		Balance of Increment Resulting from Reduction in Weight of the Gold Dollar	140.6
Federal Reserve Banks	386.7	Seigniorage	322.6
Special Depositaries, Account of Sales of Government Securities	1,134.1	Working Balance	1,611.8
National and Other Bank Depositaries:		Balance Today	$ 2,074.9
To Credit of Treasurer of United States	10.4		
To Credit of Other Government Officers	41.6		
Foreign Depositaries:			
To Credit of Treasurer of United States	1.2		
To Credit of Other Government Officers	1.5		
Philippine Treasury:			
To Credit of Treasurer of United States	2.2		
Total	$ 2,362.3	Total	$ 2,362.3

* Source: *Daily Statement of the United States Treasury*, August 15, 1936.

bank reserves control is probably the most important for the reason that the predominant medium of exchange is bank deposits circulating in the form of checks. The relationships that prevail between money and reserves, between reserves and deposits, between deposits and loans, and between loans and business fluctuations, are the basis upon which bank reserves control is expected to obtain money management results.

Bank reserves control has two phases—expansion and contraction. When reserves expand, whether as a result of management or because of other happenings, banks acquire additional lending power. If the expansion of reserves is substantial and prolonged, banks may proceed gradually to utilize them in the making of new loans or investments. The proceeds of the new loans are taken in the form of an increase in deposits, and, circulating in the form of checks, create new purchasing power. Similarly, if the initial step is an expansion of business activity, loans to facilitate the increase are requested of banks sooner or later, and decisions to grant or to refuse such loans, and to permit the consequent increase of circulating deposits, may turn upon the bank's opinion as to the adequacy or excess of the existing reserves relative to legal requirements or to estimated prospective needs. Any machinery by which reserves can be created at will and distributed to banks rather generally may be expected, therefore, either to stimulate business expansion or to facilitate such expansion when and if brought into existence by some other stimulus. Larger reserves alone and unaided may induce but cannot compel bank loan and deposit expansion.

In contrast, bank reserves control when seeking contraction has more positive and prompt reactions. Whereas expansion may be optional with banker and business man, contraction is compulsory. When reserves shrink, whether as a result of management or because of chance events, banks find their excess reserves falling, usually first, below what they consider to be adequate, and second, below what is legally required to be maintained relative to their existing deposits. If loans and investments are not reduced because the first imaginary line has been passed, such reduction ordinarily becomes a pressing matter when the line legally drawn is passed or closely approached. Then rediscounting may be utilized to defer the pressure, but rediscounting is embarrassing. Not only must the banker ask for a loan, but such rediscounts must be shown upon published statements and reveal the dependence of the bank upon others. Any device by which reserves can be contracted at will provides an ultimate veto upon business expansion and may force a contraction of any business which is dependent upon loans to maintain its necessary operating quota of deposits. It must be borne in mind, however, that the mechanisms assuring the technical control of reserves expansion and contraction *may* possess sufficient prestige to act by psychological sequence; desired effects may be obtained by mere anticipation of ultimate maximum technical action.

Today, these bank reserve controlling powers for expansion or contraction reside in the Treasury and in the Federal reserve banks. To understand and appraise the significance of each event subsequent to the action of August 15, it is necessary to survey the powers of the Treasury and of the Federal reserve banks for creating and for destroying member bank reserves available as a bank credit base. The powers of the Treasury arise from various statutory authorizations and are of two kinds, those which grant initiative and discretion to the

Secretary of the Treasury, and others which require either the direction or the approval of the President of the United States. We are assuming that the President and the Secretary of the Treasury will act as a unit, but that the Treasury and the Federal reserve banks are not a unit and may or may not act as a unit.

The action of August 15 increased required reserves from about 3 billion dollars to about 4½ billion dollars, and thereby reduced the excess reserves from about 3¼ billion dollars to about 1¾ billion dollars. The Treasury used its reserve creating powers to the extent of more than 300 million dollars between July 15, when the Board of Governors of the Federal Reserve System announced its decision to raise reserve requirements, and August 15. Thus excess reserves were reduced from about 110% to about 40% of the legal requirements for member banks as a group. It is easier to treat the banks as a group, although the probable results of any course of action will be determined by the fact that the percentage of excess reserves to required reserves is not uniform in all banks, but varies from zero (or even a minus quantity) upward.

It is not the purpose of this article, however, to determine the effects *per se* of the August 15 maneuver. The residue of powers, only, will be canvassed. No attempt will be made to forecast what *should* be done nor what *will* be done, but only to indicate what *can be* done, under existing grants of power, by the administrators of the Treasury and of the Federal reserve banks. To what extent, after August 15, can the Treasury create new bank reserves as it did between July 15 and August 15? To what extent can the Treasury contract bank reserves? How do these powers of the Treasury compare with those of the Federal reserve banks? What would be the resultant if the Treasury and the Federal reserve banks work in unison, and what if in opposition? To answer these questions, consider, first, the powers of the Treasury, *assuming the Federal reserve banks to be neutral;* second, the powers of the Federal reserve banks, *assuming the Treasury to be neutral;* and lastly, the aggregate or resultant powers when both Treasury and Federal reserve banks take simultaneous action.

Treasury Cash Funds.—The ability of the Treasury to expand or to contract bank reserves arises out of its cash position and *potential* changes in the cash and borrowings. The present cash position may be taken from the *Daily Statement of the United States Treasury* at the close of August 15, 1936 (Exhibit 1). Therein the general fund balance shown was 2 billion dollars, but a more detailed analysis of the statement is revealing. On the face of the statement, the general fund contained cash consisting of 422 million dollars in gold and silver certificates, 387 million dollars of deposits in Federal reserve banks, and 1,134 million dollars of deposits in special depositary banks. To these should be added the amount in the separate Stabilization Fund, carried on the books at 1,800 million dollars, which is available for money market release at the discretion of the Treasury. Unless extended by new legislation, the gold segregated in this fund will revert

(a mere bookkeeping entry) to the general fund early in 1937.[1] In addition, the Treasury held in the general fund as silver bullion, carried at cost, 332 million dollars which, when and if "coined" into silver dollars and issued in the form of silver certificates, would produce about double, or 664 million dollars, assuming the original cost to average one-half the coinage value of about $1.29 per ounce. Summarizing, the present cash funds readily available for manipulation total nearly 4½ billion dollars.

To supplement the foregoing, the Treasury has additional potential cash arising from certain extraordinary powers, any one or all of which may be utilized sooner or later. First, there is the power of the President to revalue the gold in the United States by changing the present "59-cent" dollar to a "50-cent" dollar. Such action would add more than 1,900 million dollars to the cash funds of the Treasury. To state the effects of further gold devaluation by the United States in such simple terms is naïve. The possible repercussions are numerous and are particularly important in determining Federal reserve bank reserves. Furthermore, devaluation of gold should not be considered apart from the silver devaluation and purchasing policies. The President also has power to devalue the silver dollars in the United States and the silver bullion in the Treasury to the same extent that the gold dollar is devalued. To revalue such present silver holdings to a 59-cent dollar would produce more than 1,300 million dollars of cash funds. To revalue them later from 59 cents to 50 cents would add nearly 600 million dollars. Purchases of additional silver bullion by the Treasury appear probable for some time to come, but it is more convenient to confine the present analysis to the potential seigniorage and profit upon the gold and silver holdings as they existed on August 15, 1936. Perhaps, also, we should overlook the power to revalue the subsidiary silver coinage at a profit of 335 million dollars, more or less, assuming that the Treasury could repossess the coins for recoinage. Most important, of all the money manufacturing "assets," there is the further power of the President to direct the Secretary of the Treasury to issue "greenbacks" (United States notes) to the extent of 3 billion dollars. Summarizing, these items of potential cash funds total more than 7 billion dollars.

The present and the potential cash funds of the Treasury, combined, therefore total 11½ billion dollars, all of which is available presumably for manipulation in money management.

Treasury Expansion.—How does and could the Treasury use its cash funds for money management? If the Treasury wishes to expand bank reserves generally throughout the United States, it can check out its present and potential balances in the Federal reserve banks. Whenever the Treasury draws its checks in payment of expenses or to redeem bonds, member and nonmember banks must perforce receive such checks on deposit from their customers. In the regular course of

[1] Act of January 30, 1934, Sec. 10, as " . . . extended for one additional year from January 30, 1936," by the Presidential Proclamation of January 10, 1936. *Federal Reserve Bulletin*, February, 1934, pp. 65–66; February, 1936, pp. 82–83.

business, the checks are forwarded, for collection, to correspondent banks who give credit therefor finally, directly or indirectly, on the books of the Federal reserve banks. By this method, treasury deposits in Federal reserve banks are converted readily into member bank reserve deposits at Federal reserve banks. The Treasury's balance of 387 million dollars at the Federal reserve banks could be augmented by 10 billion dollars; that is to say, the Treasury could deposit its present holdings of gold and silver certificates, its silver bullion after conversion into certificates, the balance in the Stabilization Fund, and the potential cash arising from the use of the extraordinary powers to revalue gold and silver and issue greenbacks. Therefore, the aggregate expansibility of member bank reserves by treasury action totals more than 10 billion dollars. Incidentally, Federal reserve bank reserves would be increased by these new treasury deposits.

Treasury Contraction.—If, on the other hand, the Treasury should wish to contract bank reserves generally throughout the United States, it could be done by two methods. First, the Treasury can withdraw all or a part of its deposits in the special depositary banks, now totaling more than 1 billion dollars. Second, it could sell, simultaneously or later, new issues of United States securities to banks or to depositors in banks, taking the proceeds in the form of checks which would then be collected and, directly or indirectly, paid by a transfer from bank-owned reserve deposits in Federal reserve banks to the Treasury's deposit account in the Federal reserve banks. Assuming that the quantity of United States securities, salable at some price, is unlimited and that the proceeds would be held *unspent* in the form of treasury deposits in Federal reserve banks, the power to shrink member bank reserves is unlimited!

Similarly, the Treasury could shrink Federal reserve bank reserves at will by the simple device of asking for the redemption of its present and potential deposit balances in the Federal reserve banks and taking payment in gold certificates or lawful money, holding them unspent in the Treasury as a part of the general fund balance. The historic controversy over "The Independent Treasury" may be revived!

The foregoing calculations have been set forth in the simple terms of ultimate limits. There is no assurance that present statutes will not be changed in either direction. It is reasonably certain that, in approaching the limits, secondary repercussions, economic or psychological, or extraneous events will produce forces setting different limits. It is generally recognized that timeliness in any form of management reduces the amount of force or energy that must be expended to obtain a given objective. It may be found, therefore, that one or two billions, wisely applied in either direction, will achieve the results desired. Be that as it may, it is apparent that the Treasury, for good or ill, possesses an enormous power with respect to the manipulation, if not the control, of member bank reserves. Perhaps it should be repeated at this point that the foregoing and the next succeeding calculations have been made on the assumption respectively of neutral Federal reserve banks and a neutral Treasury.

Federal Reserve Expansion.—On or about August 15, the Federal reserve banks had total demand liabilities of 10¾ billion dollars, reserves of 8½ billion dollars, required reserves of about 4 billion dollars, and excess reserves of 4½ billion dollars. Assuming that their required reserves are 40% of any demand liabilities, it would be possible, upon the basis of these present excess reserves, to expand Federal reserve bank deposits and notes to the extent of more than 11 billion dollars. Such added deposits and notes might arise from rediscounts for member banks or from purchases of additional government securities. In consequence, the excess reserves of member banks would be increased to the same extent, assuming that their *required* reserves would not be increased by rising individual deposits and that their *actual* reserves would not be decreased by customers demanding additional hand-to-hand currency in excess of the amounts produced by the present policy of gradually increasing the amount of silver certificates in circulation. In addition, or separately, by reversing the action of August 15 and thereby reducing reserve requirements, excess reserves of member banks could be increased about 1½ billion dollars.

Federal Reserve Contraction.—If, on the other hand, the Federal reserve banks should wish to contract bank reserves, their holdings of United States securities, totaling 2.4 billion dollars, could be sold to banks or depositors of banks, the proceeds being taken in the form of checks which would be collected and paid, finally, by member banks drawing upon and thereby reducing their reserve deposits with the Federal reserve banks. Also the Federal reserve banks have the power to increase the required reserves of member banks a remaining 50% of the July 15 base (equivalent to 33⅓% of the post-August-15 base), or by a sum of approximately 1½ billion dollars. Here, too, it is an oversimplification to use the apparent statistical limits as if they would be reached in actual practice. In a race for control, with both contestants unfolding their powers simultaneously, the test of limits is important. Without such a race, a well defined policy, convincingly begun, will engender enough "coöperation" to make full use of any limits quite unnecessary.

Selling of United States securities by Federal reserve banks tends to reduce *actual* member bank reserves, but an increase of reserve requirements merely changes the calculated amount of the *excess* (or deficient) reserves. That such selling of securities merely *tends* to reduce member bank reserves arises from the fact that the checks drawn to pay for such securities bought from the Federal reserve banks will not be drawn upon member banks in proportion to their present excess reserves. Some banks do not have excess reserves. Some banks will insist upon maintaining excess reserves. Consequently, either the selling of United States securities or a further step-up of reserve requirements will lead numerous banks to fortify their reserves by rediscounting or by selling from their portfolios. Some member banks will be unable or unwilling to sell enough securities to shift the pressure to other banks. Therefore, some rediscounting is certain to result. To that extent the Federal reserve banks will be creating credits which

will reduce the statistical (not the psychological) weight of their then projected contraction. The net result cannot now be forecast, but, for convenience, we may assume that, if the Federal reserve banks do their utmost, *actual* member bank reserves would be contracted nearly 2½ billion dollars, and the present *excess* reserves would be reduced to a *deficit* of required reserves, unless relieved by rediscounting amounting to more than 2½ billion dollars.

It is apparent that, if permitted to act independently, the Federal reserve banks have substantial powers for expansion and adequate powers for contraction of member bank reserves.

Simultaneous Action, Treasury and Federal Reserve Banks.—If, however, the Treasury and the Federal reserve banks should act simultaneously, either in unison or in conflict, as is more probable than separate neutrality of either, what are the several possibilities?

If the Treasury wishes to encourage or facilitate bank credit expansion when the Federal reserve banks seek contraction, and each should proceed to move toward the present statistical limits, the Treasury's expansibility of more than 10 billion dollars would exceed the Federal reserve banks' contractibility of 2½ billion dollars. In fact, the Treasury could dominate without using any of its extraordinary powers to produce "potential" cash funds!

If the Federal reserve banks wish to have expansion when the Treasury seeks contraction, the Federal reserve banks could create more than 12½ billion dollars of excess member bank reserves, which, added to the present excess reserves, would mean total excess reserves of about 14½ billion dollars. At first glance it appears that the Treasury could withdraw its 1 billion or more dollars now with the special depositaries, taking drafts on their reserves, and would need to sell more than 13 billion dollars of new United States securities, holding the proceeds of both as an unspent deposit in the Federal reserve banks, to counterbalance. It would not be difficult to sell such new government bonds while the Federal reserve banks were manufacturing bank reserves so liberally. The new bonds would probably be sold indirectly to the Federal reserve banks; bank rediscounting would probably not increase during such a contest. Upon closer analysis, however, it becomes evident that as an outside limit the Treasury would not need to sell more than 3 billion dollars of new securities! *By exacting settlement payments from the Federal reserve banks, in the form of lawful money drawn from their reserves*, for the present 387 million dollars of Treasury deposits in the Federal reserve banks, for the 1,134 million dollars that can be drawn from the special depositary banks, and settled by checks on the Federal reserve banks, and for the first 3 billion dollars of new securities sold, the present excess reserves of 4½ billion dollars of the Federal reserve banks would be exhausted. It would probably be easier to sell the 13 billions than the 3 billions, considering the different circumstances, but by either method the Treasury could dominate Federal reserve bank reserves!

If the Treasury and the Federal reserve banks simultaneously seek either expansion or contraction, the joint possibilities are so enormous

as to be fantastic and therefore purely conjectural. Since any reserves newly created (or destroyed) by the Treasury originate as deposits (or withdrawals) of lawful money in the Federal reserve banks, the results are compounded by the separate expansibility enjoyed by the Federal reserve banks upon the basis of such added (or reduced) lawful money reserves.

In any tug-of-war between the Treasury and the Federal reserve banks some further considerations must be mentioned and weighed. First, do the Federal reserve banks have the power to borrow funds in the open market, and if so, could such a power be used to such an extent as to negate the Treasury's expansibility? The possible illegality of such borrowing, the improbability of its use, and the unknown extent of its usableness warrant its exclusion from these calculations. Second, any speculation as to the possibilities in the present financial organization and situation must take account of the indirect effects of past and prospective gold devaluation in determining the dependence of the Federal reserve banks upon treasury monetary policy. Assuming the other nations to make no similar changes, further gold devaluation by the United States would probably tend to increase imports of gold, thereby increasing Federal reserve bank reserves. Contrariwise, revaluation upward—or such monetary tinkering as would destroy foreign confidence in the ultimate value of the dollar—would tend to promote gold exports, and a reduction of Federal reserve bank reserves. To some extent, therefore, the Treasury may control the reserves of the Federal reserve banks indirectly through foreign gold flows, as well as directly by its deposit and withdrawal rights more fully described herein. Gold devaluation by the United States might perhaps be used successfully to counterbalance any tendency for gold to move outward for any cause whatever, monetary or otherwise. The estimates made herein obviously assume that our gold stock will remain unchanged by foreign flows or domestic production. There is considerable reason for assuming that our gold holdings will not be reduced except by treasury design, because gold exports are subject to treasury regulations and discretionary license.[1]

If the Treasury should wish to renounce its powers and to make the Federal reserve banks the beneficiaries thereof, the required steps are few and simple. First, the 351 million dollars of gold in the general fund and the 1,800 million dollars of gold in the Stabilization Fund could be deposited in the Federal reserve banks and used to purchase and retire all but 275 million dollars of the United States securities held by the Federal reserve banks. Second, the Federal reserve banks could then increase member bank reserve requirements by the remaining 33⅓% of the post-August-15 base, and, simultaneously, purchase about 1½ billion dollars of United States securities from member banks, or others, in order to provide (1) the Federal reserve banks with earning assets to meet expenses and (2) member banks with enough reserves to maintain their present excess reserves without causing an immediate

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[1] *Federal Reserve Bulletin*, February, 1934, *passim*.

general financial disturbance. Third, the Treasury could agree to maintain or change its present balances in the Federal reserve banks and in the special depositary banks in accord with instructions from the Federal reserve banks.

By these three steps, the Federal reserve banks would acquire, on the one hand, enormous gold reserves for expansive use when and if needed, and, on the other hand, ample contractile power as to member bank reserves by the power (1) to sell 1¾ billion dollars of United States securities, and (2) to order the 1,134 million dollars of treasury deposits in the special depositary banks shifted to the treasury deposits in the Federal reserve banks. The total contractile power would exceed excess member bank reserves by enough to compel them to apply for rediscounts totaling more than 1 billion dollars, assuming that the mere launching of such a restrictive policy would not shrink bank lending and individual deposits. There is no doubt that the Federal reserve banks stand ready to take over full control of the manipulation of bank reserves whenever and if the Treasury relinquishes its present authority.

The foregoing assumes that the Treasury would not use any of its other powers, such as to "coin" the silver bullion on hand, to purchase more silver bullion, to issue United States notes, to devalue gold and silver, or to refuse licenses to export gold. A mere announcement by the Treasury of self-denial as to these enumerated powers would have an uncertain weight. Appropriate congressional action would be somewhat more assuring.

Congressional inaction may prove to be more important than congressional action because some of the existing powers of the Treasury are limited as to duration. For instance, the authority of the President to fix the weight of the gold dollar, silver dollar, and subsidiary silver expires January 30, 1937.[1] The authority to issue 3 billion dollars of United States notes is without limit as to time.[2] A part of the cash funds which may be created by the "coinage" of present treasury holdings of silver bullion has been deferred by executive action, but such action may be revoked or modified at any time.[3] Therefore, without congressional action before next February, it appears that the aggregate reserve creating power of the Treasury would then be reduced from the present 10 billion or more dollars to about 6¼ billion dollars—enough to blanket any unsanctioned attempt of the Federal reserve banks to force contraction.

Conclusion.—The power of the Treasury to dominate and to control the bank reserves position has been made plain. The rôle of the Federal reserve banks is merely one of initiative and coöperation, as

[1] Act of May 12, 1933, Sec. 43, paragraph (b) (2), as amended by the Act of January 30, 1934, Sec. 12, and extended for one additional year from January 30, 1936, by the Presidential Proclamation of January 10, 1936. *Federal Reserve Bulletin*, May, 1933, pp. 317–318; February, 1934, p. 66; February, 1936, pp. 82–83.

[2] Act of May 12, 1933, Sec. 43, paragraph (b) (1) *Federal Reserve Bulletin*, May, 1933, p. 317.

[3] Letter from the President to the Secretary of the Treasury, August 13, 1934, *Federal Reserve Bulletin*, September, 1934, p. 566.

EXHIBIT 2

The Elements of Treasury Monetary and Credit Control*
(In billions of dollars)

Date	"Balance Today"	Gold in General Fund	Silver Dollars and Silver Bullion in General Fund	Deposits in Federal Reserve Banks	Exchange Stabilization Fund	Special Deposits in Banks, Account of Sales of Government Securities	Excess Reserves, Member Banks of Federal Reserve System†
1934							
January 31	1.537	.141	.049	.314	.....	1.312	.866
February 28	4.902	3.147	.047	.110	.....	1.944	.891
March 31	4.818	3.041	.045	.099	.....	1.914	1.375
April 30	2.294	1.021	.047	.146	1.800	1.444	1.541
May 31	2.022	.987	.054	.060	1.800	1.315	1.623
June 30	2.582	.942	.055	.097	1.800	1.854	1.685
July 31	2.472	.897	.056	.068	1.800	1.770	1.789
August 31	2.137	.878	.099	.093	1.800	1.508	1.884
September 29	2.193	.902	.091	.200	1.800	1.390	1.754
October 31	1.812	.921	.096	.184	1.800	1.083	1.731
November 30	1.597	.935	.099	.093	1.800	.947	1.834
December 31	2.564	1.009	.114	.153	1.800	1.695	1.748
1935							
January 31	2.319	.901	.119	.125	1.800	1.562	2.035
February 28	2.081	.886	.146	.125	1.800	1.325	2.237
March 30	2.446	.896	.167	.451	1.800	1.325	2.065
April 30	1.935	.863	.157	.114	1.800	1.239	2.026
May 31	1.957	.883	.147	.107	1.800	.926	2.297
June 29	1.841	.839	.146	.118	1.800	.799	2.438
July 31	1.789	.826	.160	.201	1.800	.676	2.385
August 31	1.475	.631	.166	.126	1.800	.634	2.636
September 30	1.799	.666	.196	.165	1.800	.877	2.628
October 31	1.473	.573	.244	.118	1.800	.654	2.820
November 30	1.434	.507	.310	.113	1.800	.598	3.061
December 31	2.209	.487	.350	.600	1.800	.871	2.983
1936							
January 31	2.004	.452	.391	.520	1.800	.748	3.033
February 29	1.767	.420	.400	.456	1.800	.617	3.038
March 31	2.866	.443	.401	1.131	1.800	1.006	2.653
April 30	2.442	.449	.405	.708	1.800	.984	2.510
May 29	2.358	.506	.408	.554	1.800	.976	2.800
June 30	2.682	.432	.406	.862	1.800	1.150	2.593
July 31	2.230	.381	.393	.497	1.800	1.134	2.907
August 31	1.904	.349	.404	.167	1.800	1.132	2.458
September 30	2.188	.394	.419	.350	1.800	1.169	1.852
October 31	1.764	.329	.414	.155	1.800	1.006	2.043
November 30	1.406	.322	.400	.125	1.800	.675	2.219
December 31	1.906	.342	.394	.276	1.800	.989	2.046

EXHIBIT 2. (*Continued*)

Date	"Balance Today"	Gold in General Fund	Silver Dollars and Silver Bullion in General Fund	Deposits in Federal Reserve Banks	Exchange Stabilization Fund	Special Deposits in Banks, Account of Sales of Government Securities	Excess Reserves, Member Banks of Federal Reserve System†
1937							
January 30	1.726	.446	.438	.207	1.800	.730	2.093
February 27	1.539	.529	.450	.217	1.800	.442	2.152
March 31	1.826	.671	.455	.367	1.800	.426	1.371
April 30	1.702	.900	.446	.132	1.800	.318	1.552
May 29	1.754	1.094	.437	.111	1.800	.192	.927
June 30	2.553	1.428	.409	.141	1.800	.649	.876
July 31	2.639	1.558	.435	.247	1.800	.501	.876
August 31	2.902	1.684	.449	.168	1.800	.685	.750
September 30	2.860	1.561	.446	.161	1.800	.768	.900
October 30	2.676	1.628	.464	.128	1.800	.552	1.043
November 30	2.608	1.602	.462	.132	1.800	.485	1.104
December 31	2.973	1.592	.468	.181	1.800	.835	1.071
1938							
January 31	2.950	1.591	.511	.168	1.800	.776	1.353
February 28	2.975	1.556	.499	.209	1.800	.776	1.406
March 31	3.140	1.535	.485	.373	1.800	.811	1.524
April 30	2.689	.182	.494	1.360	1.800	.728	2.071
May 31	2.567	.232	.514	1.203	1.800	.679	2.525
June 30	2.216	.283	.513	.929	1.800	.611	2.762
July 30	2.116	.341	.511	.777	1.800	.585	3.026
August 31	2.260	.462	.521	.778	1.800	.556	2.955
September 30	2.978	.809	.513	.963	1.800	.791	2.920
October 31	2.569	.761	.532	.603	1.800	.747	3.143
November 30	2.447	.668	.559	.570	1.800	.736	3.276
December 30	3.084	.682	.583	1.033	1.800	.888	3.226
1939							
January 31	2.933	.703	.638	.792	1.800	.876	3.484
February 28	3.343	.719	.593	1.222	1.800	.873	3.373
March 31	3.389	.675	.597	1.388	1.800	.866	3.432
April 29	3.044	.658	.631	.975	1.800	.858	3.926
May 31	2.924	.602	.634	.971	1.800	.792	4.212
June 30	2.838	.558	.615	1.022	1.800	.776	4.246
July 31	2.447	.332	.645	.928	1.800	.771	4.402
August 31	2.231	.297	.653	.748	1.800	.761	4.607
September 30	2.178	.226	.647	.586	1.800	.758	5.198
October 31	1.913	.227	.656	.318	1.800	.756	5.490
November 30	2.166	.356	.643	.471	1.800	.755	5.259
December 29	2.476	.409	.634	.673	1.800	.825	5.011

* Source: *Daily Statement of the United States Treasury*, for the dates indicated.
† Monthly average of daily figures, *Federal Reserve Bulletin*.

modified by the opportunity to attempt persuasion while subject to the Treasury's coercive veto. The action of August 15, shrinking reserves, could not have been taken without treasury sanction. The Federal reserve banks may lead, but the final responsibility rests with the Treasury.

The general significance to bankers and business men of the Treasury's dominance is equally plain. The judgment, the discretion, or the whim of treasury management under the same or shifting administrations may determine the prevailing policy. A strong, unified, intelligent public opinion is needed to lead or to support treasury action. As it now is, no rule of action has been created by law or by precedent to guide the Treasury. In consequence, financial and banking administrators must engage experts to guess, from day to day, prospective treasury policy, and must grope, during a long period of experimentation, for adequate means of utilization or insulation.

The ability of the United States to export an enormous quantity of gold is apparent. The Treasury and the Federal reserve banks could provide more than 7 billion dollars for export without necessarily restricting the present extraordinary volume of circulating deposits and excess reserves of member banks. Should we achieve an export of but 3 billions, the United States would make a substantial contribution to world business recovery.

Finally, attention should be directed to the possibilities of financial control, such as the Federal Government may wish to exercise, by the use of other measures than those operating through the banking mechanism as herein set forth. Government expenditures and tax measures may affect the velocity of circulation of available currency and deposits, the borrowing propensities of business concerns and of individuals, and the allocation of capital provision between banks and investors. Likewise the new power of the Board of Governors of the Federal Reserve System to regulate margins on stock exchange collateral loans may determine the amount of speculative holdings of securities financed by loans. To pursue the money market controls arising from the power of the Board of Governors of the Federal Reserve System to change margin requirements and from other types of regulation and supervision by the Securities and Exchange Commission is quite outside the purview of this article.[1]

Outline the possible objectives of United States monetary management, and estimate their contemporary relative importance. Wherein are such objectives different from those of central bank control?

Contrast the methods used and results obtained in selecting executives for typical governmental monetary management with those of typical central bank credit management.

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[1] Ebersole, J. F., "The Money Management Powers of the Treasury and Federal Reserve Banks," *Harvard Business Review*, Autumn, 1936, pp. 1–9.

Describe in detail the possible and probable steps that will be taken by United States monetary management when and if "enough" money and credit have been created. Forecast the probable effects upon banks when and if United States monetary management attempts to reduce the volume of money and credit.

What specific recommendation should have been made to banks as of August 15, 1936 (or of any particular subsequent date), as to the following: (*a*) increasing or diminishing their own excess reserves, (*b*) increasing or reducing their holdings of United States Government securities, (*c*) shifting holdings of United States Government securities from long to short, or short to long, maturities, and (*d*) increasing other loans and investments?

APPENDICES

APPENDIX I

SELECTED INDEXES OF SEASONAL VARIATION*

	Period	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Automobiles. General Motors Cars Sold *to* Dealers	1924–31	83	104	130	140	137	117	97	109	103	79	49	51
General Motors Cars Sold to Users	1922–31	64	80	119	152	144	122	105	109	97	92	62	54
Construction. Contracts Awarded, Total Value	1923–31	77	76	113	119	113	115	105	101	102	104	88	86
Index of Volume	1924–31	71	65	68	86	102	117	121	124	127	119	115	87
Pavements, Concrete. New Orders	1923–31	53	58	100	156	158	134	129	120	93	78	51	69
Construction Materials. Lumber													
Western Pine, Production	1924–31	52	60	99	118	123	125	120	126	110	108	92	68
Mill Stocks (Computed)	1922–31	98	95	94	96	98	100	102	102	103	104	105	104
Radiators, Production	1925–31	108	109	116	104	100	92	85	101	102	114	92	77
Shipments	1925–31	75	65	60	65	81	85	104	130	138	164	133	102
Cotton. Marketing by Farmers	1919–30	72	53	48	35	32	27	25	51	186	280	238	153
Stocks at Public Warehouses, United States	1923–31	141	121	100	82	67	52	41	45	91	143	159	158
Stocks at Mills, United States.	1919–27	122	122	122	114	104	93	80	66	67	86	105	119
Finished Goods—Manufacturers' Stocks (Computed)	1921–31	99	95	96	100	100	102	102	100	97	100	103	105
Factory Payrolls. Woolen and Worsted	1923–31	102	103	100	97	98	98	94	98	99	103	104	105
Leather. Total Production, Upper	1921–31	104	99	106	96	94	97	94	103	100	107	96	102
Shoes, Production	1926–31	91	96	109	101	93	94	98	120	117	114	89	77
Retail Trade. Sales of New England Department Stores, Men's and Boys' Shoes	1926–30	86	73	97	101	91	107	65	63	95	96	104	220
Volume of Trade—Copeland	1919–27	91	86	102	103	99	96	84	86	94	112	108	137
Tomatoes. Harvest Estimate	....	0	0	0	37	16	46	137	350	476	116	18	4
Wheat. Marketing by Farmers	1919–30	56	54	42	35	30	53	196	229	197	138	92	70
Visible Supply	1923–31	113	106	95	80	66	53	72	110	123	120	128	125
Wheat Flour. Stocks, All Positions	1920–31	99	96	91	92	87	88	104	108	116	116	108	96
Wholesale Trade. Dry Goods Stocks, Philadelphia Federal Reserve District	1924–31	96	101	101	100	98	98	102	107	100	104	96	89
Wool, Raw. Stocks, Quarterly. Dealers'	1923–29	...	...	74	...	...	122	...	...	113	...	..	91
Manufacturers'	1918–29	...	...	101	...	...	100	...	...	101	...	...	98

* Source: Kuznets, Simon, *Seasonal Variations in Industry and Trade*. Appendix I, pp. 372–415; copyrighted, 1933, by National Bureau of Economic Research, Inc., and reprinted by permission of publisher and author. The selection has been made primarily for illustrative purposes in connection with cases appearing in this volume. Additional useful indexes may be found in other publications, or made up from a bank's files.

APPENDIX II

SELECTED MONTHLY INDEXES OF GENERAL BUSINESS CONDITIONS

Part 1. Index of Industrial Production (Adjusted)*

	1920	1922	1924	1926	1928	1930	1932	1934	1936	1938
January..	95	73	100	106	107	106	72	78	97	80
February..	95	76	102	105	109	107	69	81	94	79
March. ..	93	80	100	106	108	103	67	84	93	79
April.....	88	77	95	107	108	104	63	86	101	77
May.....	90	81	89	106	108	102	60	86	101	76
June.....	91	85	85	108	108	98	59	84	104	77
July......	89	85	84	108	109	93	58	76	108	83
August ..	89	83	89	110	110	90	60	73	108	88
September	86	88	94	111	113	90	66	71	109	90
October. .	83	93	95	111	115	88	67	74	110	96
November	76	97	97	110	117	86	65	75	114	103
December	72	100	101	107	118	84	66	86	121	104

	1921	1923	1925	1927	1929	1931	1933	1935	1937	1939
January. .	67	99	105	107	119	83	65	90	114	101
February..	66	100	104	108	118	86	63	90	116	99
March....	64	103	103	110	118	87	59	88	118	98
April.....	64	106	102	108	121	88	66	86	118	92
May.....	66	106	102	109	122	87	78	85	118	92
June	65	106	102	107	125	83	91	87	114	98
July......	65	104	103	106	124	82	100	86	114	101
August .	67	103	103	106	121	78	91	88	117	103
September	68	100	101	104	121	76	84	91	111	111
October...	71	99	104	102	118	73	76	95	102	121
November	71	98	107	101	110	73	72	96	88	124
December	70	97	109	102	103	74	75	101	84	128

Part 2. Wholesale Commodity Prices†

	1920	1922	1924	1926	1928	1930	1932	1934	1936	1938
January...	157.7	91.4	99.6	103.2	96.4	92.5	67.3	72.2	80.6	80.9
February..	157.1	92.0	99.7	102.0	95.8	91.4	66.3	73.6	80.6	79.8
March....	158.6	92.8	98.5	100.6	95.5	90.2	66.0	73.7	79.6	79.7
April.....	165.5	93.2	97.3	100.3	96.6	90.0	65.5	73.3	79.7	78.7
May.....	167.2	96.1	95.9	100.5	97.5	88.8	64.4	73.7	78.6	78.1
June.....	166.5	96.3	94.9	100.4	96.7	86.8	63.9	74.6	79.2	78.3
July......	165.8	99.4	95.6	99.5	97.4	84.4	64.5	74.8	80.5	78.8
August...	161.4	98.6	97.0	99.1	97.6	84.3	65.2	76.4	81.6	78.1
September	155.2	99.3	97.1	99.7	98.6	84.4	65.3	77.6	81.6	78.3
October...	144.2	99.6	98.2	99.4	96.7	83.0	64.4	76.5	81.5	77.6
November	133.4	100.5	99.1	98.4	95.8	81.3	63.9	76.5	82.4	77.5
December	120.7	100.7	101.5	97.9	95.8	79.6	62.6	76.9	84.2	77.0

	1921	1923	1925	1927	1929	1931	1933	1935	1937	1939
January...	114.0	102.0	102.9	96.5	95.9	78.2	61.0	78.8	85.9	76.9
February..	104.9	103.3	104.0	95.8	95.4	76.8	59.8	79.5	86.3	76.9
March....	102.4	104.5	104.2	94.7	96.1	76.0	60.2	79.4	87.8	76.7
April.....	98.9	103.9	101.9	94.1	95.5	74.8	60.4	80.1	88.0	76.2
May.....	96.2	101.9	101.6	94.2	94.7	73.2	62.7	80.2	87.4	76.2
June.....	93.4	100.3	103.0	94.1	95.2	72.1	65.0	79.8	87.2	75.6
July......	93.4	98.4	104.3	94.3	96.5	72.0	68.9	79.4	87.9	75.4
August...	93.5	97.8	103.9	95.2	96.3	72.1	69.5	80.5	87.5	75.0
September	93.4	99.7	103.4	96.3	96.1	71.2	70.8	80.7	87.4	79.1
October...	94.1	99.4	103.6	96.6	95.1	70.3	71.2	80.5	85.4	79.4
November	94.2	98.4	104.5	96.3	93.5	70.2	71.1	80.6	83.3	79.2
December	92.9	98.1	103.4	96.4	93.3	68.6	70.8	80.9	81.7	79.2

* Source: Federal Reserve Board. Adjusted for seasonal variation; 1923 to 1925 equals 100. *Annual Report of the Federal Reserve Board*, 1933, 1936, 1938, and *Federal Reserve Bulletin*.

† Source: United States Department of Labor. Bureau of Labor Statistics. 784 price series; 1926 equals 100. For current figures, see *Federal Reserve Bulletin*.

APPENDIX III

MONEY RATES—MONTHLY FIGURES, 1920 AND LATER

Month	Commercial Paper Prime 4–6 Months New York*	Bankers' Acceptances Prime 90 Days New York†	Call Loans New York Renewals‡	Time Loans New York Stock Exchange 60–90 Days§	Rediscount Rate Federal Reserve Bank of New York	U. S. Treasury Notes and Certificates 3–6 Months‡	U. S. Liberty and Treasury Bonds¶	High-Grade Bonds**	Bankers' Acceptances 3 Months London††	British Treasury Bills 3 Months‡‡
1920										
January	6	5.37	8.10	7.25	4¾–6	4.50	4.08	5.50	....	....
February	6½	5.50	9.61	8.13	6	4.50	5.09	5.64	....	....
March	6¾	6.00	8.17	8.19	6	4.75	5.14	5.65	....	....
April	7	6.00	7.23	8.10	6	5.25	5.35	5.81	....	....
May	7½	6.13	7.10	8.25	6	5.50	5.65	6.00	....	....
June	7¾	6.25	7.36	8.06	7	5.75	5.59	6.10	....	....
July	8	6.25	8.14	8.28	7	5.81	5.63	6.11	....	....
August	8	6.25	7.25	8.72	7	5.83	5.73	6.06	....	....
September	8	6.25	7.10	8.41	7	5.81	5.63	5.05	....	....
October	8	6.25	7.75	7.89	7	5.75	5.36	5.81	....	....
November	8	6.23	7.83	7.85	7	5.75	5.54	5.86	....	....
December	8	6.25	7.00	7.30	7	5.88	5.76	6.03	....	....
1921										
January	7¾	5.94	6.72	6.60	7	5.67	5.48	5.80	....	....
February	7¾	5.97	7.27	6.81	7	5.30	5.55	5.88	....	....
March	7¾	5.98	6.83	6.75	7	5.38	5.52	5.91	....	....
April	7½	5.67	6.54	6.68	7	5.20	5.48	5.90	....	....
May	7	5.69	6.78	6.60	7 –6½	5.16	5.49	5.01	....	....
June	6½	5.59	5.98	6.75	6½–6	4.99	5.49	6.00	....	....
July	6¼	5.25	5.58	6.20	6 –5½	4.60	5.47	5.07	....	....
August	6¼	5.00	5.56	6.00	5½	4.75	5.40	5.85	....	....
September	6	4.94	5.12	5.65	5½–5	4.75	5.28	5.76	....	....
October	5¾	4.49	5.23	5.38	5	4.21	4.98	5.69	....	....
November	5¼	4.27	4.97	5.19	5 –4½	4.03	4.73	5.50	....	....
December	5	4.16	5.14	5.13	4½	3.90	4.54	5.29	....	....
1922										
January	4¾	3.95	4.52	4.75	4½	3.90	4.54	5.17	....	....
February	5	4.00	4.90	4.85	4½	3.81	4.58	5.13	....	....
March	4¾	3.73	4.22	4.74	4½	3.55	4.44	5.07	....	....
April	4½	3.32	3.97	4.41	4½	3.21	4.30	4.97	....	....
May	4¾	3.18	3.90	4.19	4½	3.25	4.27	4.94	....	....
June	4¼	3.07	3.72	4.13	4½–4	3.25	4.25	4.93	....	....
July	4	3.00	3.86	4.30	4	3.20	4.18	4.87	....	....
August	4	3.00	3.75	4.22	4	3.13	4.18	4.81	....	....
September	4¼	3.12	4.34	4.44	4	3.34	4.22	4.77	....	....

1922 (*Continued*)										
October	4½	3.72	4.73	4.71	4	3.71	4.33	4.82	....	....
November	4¾	4.00	4.89	4.96	4	3.66	4.43	4.90	....	....
December	4¾	4.00	4.65	4.93	4	3.65	4.42	4.87	....	....
1923										
January	4½	3.98	4.32	4.66	4	3.66	4.41	4.86	....	....
February	4¾	3.99	4.82	4.85	4 -4½	3.65	4.41	4.89	....	....
March	5	4.00	5.14	5.23	4½	4.12	4.49	4.97	....	....
April	5 -5¼	4.14	4.87	5.31	4½	4.13	4.51	5.00	....	....
May	5	4.13	4.70	5.11	4½	3.95	4.48	4.98	....	....
June	5	4.13	5.00	4.88	4½	3.84	4.44	4.98	....	....
July	5	4.13	5.06	5.13	4½	3.91	4.43	5.01	....	....
August	5¼	4.13	4.97	5.25	4½	3.86	4.43	4.99	....	....
September	5¼-5½	4.13	4.93	5.44	4½	4.01	4.45	5.02	....	....
October	5¼	4.13	4.75	5.31	4½	4.22	4.50	5.02	....	....
November	5	4.13	4.80	4.99	4½	3.94	4.44	5.01	....	....
December	4¾-5	4.13	4.86	4.94	4½	3.88	4.41	5.01	....	....
1924										
January	4¾	4.09	4.39	4.75	4½	3.76	4.32	4.95	3.29	3.26
February	4¾	4.07	4.33	4.72	4½	3.54	4.29	4.95	3.54	3.32
March	4½-4¾	4.04	4.04	4.67	4½	3.57	4.29	4.96	3.20	3.05
April	4½	3.95	4.21	4.31	4½	3.38	4.24	4.95	3.07	2.96
May	4¼-4½	3.29	3.38	3.94	4	2.99	4.15	4.90	3.05	2.97
June	3½-3¾	2.45	2.25	3.26	4 -3½	2.44	4.01	4.84	3.03	2.98
July	3¼-3½	2.01	2.10	2.75	3½	1.92	3.94	4.80	3.59	3.49
August	3 -3¼	2.10	2.00	2.52	3½-3	1.90	3.92	4.80	3.79	3.76
September	3¼	2.33	2.07	2.81	3	2.14	3.95	4.78	3.74	3.71
October	3 -3¼	2.21	2.32	2.68	3	2.41	3.93	4.77	3.72	3.64
November	3¼-3½	2.37	2.42	3.21	3	2.58	3.98	4.76	3.72	3.69
December	3½-3¾	2.89	3.49	3.34	3	2.57	4.05	4.78	3.73	3.71
1925										
January	3½	3.00	3.32	3.64	3	2.61	4.04	4.78	3.80	3.73
February	3¾	3.08	3.60	3.66	3 -3½	2.62	4.02	4.76	3.83	3.94

* Prevailing rates. *Annual Report of the Federal Reserve Board*, 1927, 1930, 1933, 1936, 1938, and *Federal Reserve Bulletin.*

† Monthly averages of daily quotations, prior to 1931, *Annual Report of the Federal Reserve Board*, 1927, 1930. Prevailing rates monthly are given in the *Federal Reserve Bulletin* and were used herein for the months of 1931 through 1939.

‡ Monthly averages of daily quotations. *Annual Report of the Federal Reserve Board*, 1927, 1930, 1933, 1936, 1938, and *Federal Reserve Bulletin.*

§ Monthly averages of weekly high and low rates as arranged in this appendix, this series changes from "60–90 Days" to "90 Days" in January, 1931. Standard Statistics Company, *Basic Statistics*, and *Current Statistics.*

‖ Actual rates. Discount Rates of the Federal Reserve Banks, 1914–1921, *Annual Report of the Federal Reserve Board*, 1930, 1933, 1936, 1938, and *Federal Reserve Bulletin.*

¶ Monthly averages of daily computed yields. For the months preceding January, 1927, based on the 2nd, 3rd, and 4th 4¼% Liberty bonds. For January, 1927, to March, 1928, based on 3¾%, 4%, and 4¼% treasury bonds, maturing 1956, 1954, and 1952. For April, 1928 to December, 1930, based on 3⅜%, 3¾%, and 4% treasury bonds, yields being calculated on the basis of the last redemption dates, 1947, 1956, and 1954. *Annual Report of the Federal Reserve Board*, 1927, 1930. After January, 1931, based on a varying list of bonds, as described in *Federal Reserve Bulletin*, June, 1934, p. 322. Data after 1934 include bonds due and callable after eight years, and after twelve years beginning in 1937. For a description, see *Federal Reserve Bulletin*, December, 1938, pp. 1045–1046. For data, see *Federal Reserve Bulletin.*

** Average yield of 60 bonds. For the months preceding May, 1930, based on the mean of monthly high and low prices of each bond. Later based on Wednesday closing prices. Standard Statistics Company, *Basic Statistics.*

†† Monthly averages of daily quotations. *Annual Report of the Federal Reserve Board*, 1927, 1930, 1933, 1936, 1938, *Federal Reserve Bulletin.* Not available prior to January, 1924.

‡‡ Monthly averages of Friday computed yields. *Federal Reserve Bulletin.* Not available prior to January, 1924.

MONEY RATES—MONTHLY FIGURES, 1920 AND LATER. (*Continued*)

Month	Commercial Paper Prime 4–6 Months New York*	Bankers' Acceptances Prime 90 Days New York†	Call Loans New York Renewals‡	Time Loans New York Stock Exchange 60–90 Days§	Rediscount Rate Federal Reserve Bank of New York	U. S. Treasury Notes and Certificates 3–6 Months⁑	U. S. Liberty and Treasury Bonds¶	High-Grade Bonds**	Bankers' Acceptances 3 months London††	British Treasury Bills 3 Months‡‡
1925 (*Continued*)										
March	4	3.25	3.97	4.05	3½	2.78	4.02	4.76	4.48	4.34
April	4	3.14	3.86	3.85	3½	2.78	3.96	4.72	4.30	4.22
May	3¾–4	3.17	3.82	3.63	3½	2.73	3.93	4.67	4.59	4.32
June	3¾–4	3.25	3.97	3.80	3½	2.86	3.90	4.66	4.44	4.43
July	3¾–4	3.25	4.09	3.94	3½	3.06	3.95	4.69	4.35	4.25
August	4 –4¼	3.27	4.19	4.38	3½	3.01	3.98	4.72	3.94	3.87
September	4¼	3.50	4.62	4.45	3½	3.33	3.98	4.72	3.68	3.65
October	4¼–4½	3.50	4.87	4.78	3½	3.53	4.02	4.73	3.57	3.81
November	4¼–4½	3.50	4.75	4.93	3½	3.65	4.04	4.74	3.92	3.91
December	4¼–4½	3.50	5.32	4.99	3½	3.51	4.04	4.70	4.67	4.90
1926										
January	4¼–4½	3.67	4.33	4.77	3½–4	3.40	4.04	4.66	4.76	4.78
February	4¼	3.63	4.85	4.63	4	3.18	4.01	4.63	4.31	4.25
March	4¼–4½	3.63	4.55	4.70	4	3.25	3.98	4.63	4.37	4.34
April	4¼–4½	3.42	4.06	4.19	4 –3½	3.08	3.94	4.61	4.33	4.34
May	4	3.20	3.81	4.03	3½	3.17	3.93	4.58	4.37	4.43
June	4	3.32	4.15	4.13	3½	2.90	3.90	4.58	4.27	4.20
July	4 –4¼	3.38	4.27	4.38	3½	3.11	3.93	4.60	4.26	4.20
August	4¼–4½	3.57	4.52	4.67	3½–4	3.27	3.95	4.59	4.45	4.55
September	4½–4¾	3.88	5.02	4.93	4	3.47	3.96	4.60	4.54	4.65
October	4½–4¾	3.88	4.75	4.95	4	3.58	3.95	4.60	4.60	4.80
November	4½	3.79	4.56	4.64	4	3.35	3.91	4.56	4.57	4.80
December	4½	3.83	5.16	4.69	4	3.11	3.84	4.55	4.53	4.60
1927										
January	4 –4½	3.69	4.32	4.47	4	3.23	3.60	4.54	4.17	4.21
February	4 –4¼	3.69	4.03	4.38	4	3.29	3.58	4.53	4.19	4.32
March	4 –4¼	3.63	4.13	4.40	4	3.21	3.48	4.51	4.33	4.36
April	4 –4¼	3.63	4.18	4.36	4	3.39	3.47	4.47	4.04	4.04
May	4 –4¼	3.63	4.26	4.31	4	3.33	3.44	4.46	3.88	3.84
June	4¼	3.63	4.33	4.44	4	3.09	3.47	4.51	4.34	4.36
July	4¼	3.50	4.05	4.34	4	2.96	3.48	4.51	4.33	4.33
August	4	3.13	3.68	3.98	4 –3½	2.70	3.45	4.48	4.33	4.35
September	4	3.13	3.83	4.11	3½	2.81	3.44	4.45	4.32	4.33
October	4	3.25	3.90	4.25	3½	3.08	3.43	4.43	4.32	4.33
November	4	3.25	3.60	4.05	3½	3.04	3.39	4.42	4.33	4.34
December	4	3.25	4.38	4.15	3½	3.17	3.34	4.40	4.31	4.31

1928										
January	4	3.36	4.24	4.34	3½	3.31	3.35	4.38	4.19	4.13
February	4	3.51	4.38	4.51	3½–4	3.33	3.36	4.38	4.18	4.18
March	4 –4¼	3.52	4.47	4.61	4	3.27	3.30	4.37	4.12	4.07
April	4¼–4½	3.81	5.08	4.93	4	3.62§§	3.32	4.38	4.02	4.01
May	4½	3.94	5.70	5.19	4 –4½	3.90§§	3.35	4.42	3.97	3.95
June	4¾–5	4.05	6.21	5.73	4½	3.92§§	3.40	4.50	3.82	3.80
July	5 –5¼	4.32	6.05	5.94	4½–5	4.12	3.50	4.54	3.99	3.97
August	5¼–5½	4.62	6.87	6.30	5	4.36	3.56	4.59	4.27	4.26
September	5½–5¾	4.50	7.26	6.97	5	4.57	3.54	4.57	4.23	4.19
October	5½	4.50	6.98	7.09	5	4.70	3.55	4.57	4.35	4.37
November	5¼–5½	4.50	6.67	6.88	5	4.26	3.48	4.55	4.38	4.30
December	5¼–5½	4.50	8.60	7.63	5	4.26	3.53	4.59	4.37	4.37
1929										
January	5¼–5½	4.84	7.05	7.65	5	4.66	3.59	4.60	4.32	4.29
February	5½	5.15	7.06	7.69	5	4.39	3.66	4.65	5.05	4.96
March	5¾–6	5.34	9.10	8.00	5	4.60	3.76	4.69	5.33	5.30
April	6	5.46	8.89	8.60	5	4.80	3.67	4.69	5.21	5.18
May	6	5.48	8.91	8.70	5	5.09	3.67	4.69	5.21	5.21
June	6	5.49	7.70	8.16	5	4.80	3.71	4.73	5.32	5.35
July	6	5.16	9.23	7.90	5	4.55	3.68	4.73	5.38	5.39
August	6 –6¼	5.13	8.23	8.88	5 –6	4.70	3.72	4.74	5.47	5.48
September	6¼	5.13	8.50	8.94	6	4.58	3.70	4.76	5.59	5.63
October	6¼	5.01	6.43	7.88	6	4.37	3.67	4.73	6.13	6.19
November	5¼–6¼	4.23	5.44	5.44	5 –4½	3.47	3.45	4.70	5.35	5.30
December	5	3.90	4.83	4.83	4½	3.03	3.40	4.64	4.76	4.75
1930										
January	4¾–5	3.96	4.64	4.70	4½	3.39	3.51	4.64	4.07	4.04
February	4½–5	3.77	4.32	4.66	4½–4	3.36	3.50	4.65	3.82	3.72
March	3¾–4¾	3.07	3.69	4.16	4 –3½	2.95	3.40	4.56	2.78	2.55
April	3¾–4	2.91	4.00	4.05	3½	3.00	3.46	4.55	2.48	2.49
May	3½–4	2.48	3.12	3.41	3½–3	2.41	3.41	4.54	2.16	2.11
June	3¼–3¾	2.09	2.62	2.88	3 –2½	1.89	3.37	4.52	2.31	2.30
July	3 –3½	1.88	2.20	2.68	2½	1.83	3.37	4.49	2.37	2.38
August	3	1.88	2.21	2.50	2½	1.53	3.38	4.43	2.21	2.17
September	3	1.88	2.19	2.44	2½	1.77	3.37	4.41	2.07	2.05
October	3	1.88	2.00	2.38	2½	1.74	3.34	4.41	2.09	2.13
November	2¾–3	1.88	2.00	2.16	2½	1.40	3.32	4.46	2.18	2.15
December	2¾–3	1.88	2.23	2.28	2½–2	1.48	3.34	4.55	2.30	2.34

§§ Based, at least in part, on certificates of 6–9 months' maturity.
For other footnotes, see p. 593.

MONEY RATES—MONTHLY FIGURES, 1920 AND LATER. (*Continued*)

Month	Commercial Paper Prime 4–6 Months* New York	Bankers' Acceptances Prime 90 Days New York†	Call Loans New York Renewals‡	Time Loans New York Stock Exchange 90 Days§	Rediscount Rate Federal Reserve Bank of New York	United States Treasury Bills¶¶	United States Treasury 3–5 Year Notes***	United States Treasury Bonds¶	High-Grade Bonds**	Bankers' Acceptances 3 Months London††	British Treasury Bills 3 Months‡‡
1931											
January	2¾–3	1⅜–1¾	1.57	1.91	2	0.95		3.17	4.43	2.25	2.24
February	2½–2¾	1¼–1½	1.50	1.69	2	1.21		3.27	4.44	2.56	2.37
March	2½	1½	1.55	1.88	2	1.46		3.26	4.41	2.60	2.56
April	2¼–2½	1½	1.52	1.88	2	1.33		3.24	4.43	2.58	2.57
May	2–2¼	⅞–1⅛	1.45	1.56	2–1½	1.08		3.13	4.43	2.24	2.21
June	2	⅞	1.50	1.38	1½	0.63		3.10	4.45	2.00	2.10
July	2	⅞	1.50	1.40	1½	0.49		3.11	4.44	2.58	2.44
August	2	⅞	1.50	1.44	1½	0.60		3.13	4.50	4.28	4.21
September	2	⅞–1¼	1.50	1.65	1½	1.22		3.24	4.70	4.74	4.57
October	2–4¼	1¼–3¼	2.10	3.22	1½–3½	2.47		3.62	5.12	5.68	5.46
November	3¾–4¼	2⅞–3¼	2.50	3.44	3½	2.22		3.50	5.14	5.75	5.55
December	3¾–4	3	2.70	3.40	3½	3.25		3.92	5.76	5.85	5.60
1932											
January	3¾–4	2¾–3	2.65	3.56	3½	2.68		4.32	5.77	5.52	4.94
February	3¾–4	2¾–2⅞	2.50	3.63	3½–3	2.66		4.11	5.82	4.63	4.08
March	3½–3¾	2⅜–2⅝	2.50	3.18	3	2.08		3.91	5.62	2.59	2.28
April	3¼–3¾	⅞–2⅛	2.50	2.44	3	0.77		3.66	5.93	2.10	2.07
May	2¾–3½	⅞–1⅛	2.50	1.59	3	0.43		3.71	6.34	1.44	1.10
June	2½–3	⅞	2.50	1.50	3–2½	0.41		3.73	6.64	1.05	0.85
July	2¼–2¾	¾	2.08	1.44	2½	0.42		3.55	6.42	0.92	0.66
August	2–2½	¾	2.00	1.38	2½	0.44		3.42	5.57	0.74	0.60
September	2–2¼	¾	2.00	1.28	2½	0.23		3.38	5.35	0.67	0.55
October	1¾–2¼	½–¾	1.35	1.03	2½	0.18		3.39	5.50	0.82	0.71
November	1½–1¾	½	1.00	0.53	2½	0.18		3.39	5.68	0.80	0.82
December	1¼–1¾	⅜	1.00	0.50	2½	0.09		3.31	5.75	1.02	1.04
1933											
January	1¼–1½	¼–⅜	1.00	0.50	2½	0.21	2.40	3.19	5.59	0.87	0.76
February	1¼–1½	¼–⅝	1.00	0.66	2½	0.49	2.54	3.29	5.73	0.83	0.78
March	1½–4½	1⅛–3⅜	3.32	2.80	2½–3½	2.20	3.00	3.44	6.25	0.62	0.46
April	2–3¼	½–1¼	1.37	1.19	3½–3	0.57	2.00	3.43	6.38	0.50	0.50
May	2–2¼	½	1.00	0.88	3–2½	0.42	2.68	3.31	5.78	0.50	0.37
June	1½–2	⅜	1.00	0.88	2½	0.27	2.53	3.22	5.37	0.50	0.40
July	1½–1¾	⅜–½	1.00	1.11	2½	0.37	2.40	3.20	5.15	0.48	0.40
August	1½	⅜–½	0.98	1.05	2½	0.21	2.48	3.21	5.12	0.41	0.30
September	1¼–1½	¼	0.75	0.62	2½	0.10	2.31	3.20	5.28	0.44	0.31
October	1¼	¼	0.75	0.63	2½–2	0.16	2.32	3.22	5.39	0.79	0.73
November	1¼	¼–½	0.75	0.77	2	0.42	2.98	3.46	5.72	1.05	0.94
December	1¼–1½	⅝	0.94	1.01	2	0.70	3.23	3.53	5.63	1.06	1.15

1934											
January.....	1¼–1½	½	1.00	1.00	2	0.67	3.11	3.50	5.25	1.01	0.90
February....	1¼–1½	½	1.00	0.88	2 –1½	0.63	2.80	3.32	4.90	0.95	0.86
March......	1 –1¼	¼– ½	1.00	0.88	1½	0.08	2.43	3.21	4.74	0.95	0.84
April.......	1 –1¼	⅛– ¼	1.00	0.88	1½	0.08	2.05	3.12	4.61	0.96	0.89
May........	1	⅛– ¼	1.00	0.88	1½	0.06	1.92	3.01	4.56	0.91	0.85
June.......	¾–1	⅛– ¼	1.00	0.88	1½	0.07	1.73	2.94	4.47	0.91	0.85
July........	¾–1	⅛– ¼	1.00	0.88	1½	0.08	1.57	2.85	4.45	0.87	0.76
August.....	¾–1	⅛– ¼	1.00	0.88	1½	0.20	1.75	2.99	4.55	0.79	0.74
September..	¾–1	⅛– ¼	1.00	0.88	1½	0.27	2.25	3.20	4.63	0.73	0.61
October.....	¾–1	⅛– 3/16	1.00	0.83	1½	0.21	2.00	3.08	4.51	0.77	0.68
November...	¾–1	⅛	1.00	0.88	1½	0.22	1.99	3.05	4.48	0.45	0.29
December...	¾–1	⅛	1.00	0.88	1½	0.15	1.78	2.97	4.40	0.57	0.47
1935											
January.....	¾–1	⅛	1.00	0.88	1½	0.14	1.60	2.83	4.32	0.36	0.26
February....	¾	⅛	1.00	0.88	1½	0.17	1.42	2.73	4.32	0.38	0.28
March......	¾	⅛	1.00	0.88	1½	0.16	1.21	2.69	4.41	0.57	0.50
April.......	¾	⅛	0.64	0.61	1½	0.17	1.20	2.64	4.34	0.59	0.51
May........	¾	⅛	0.25	0.27	1½	0.15	1.12	2.61	4.32	0.59	0.51
June.......	¾	⅛	0.25	0.25	1½	0.13	1.14	2.61	4.26	0.71	0.64
July........	¾	⅛	0.25	0.25	1½	0.07	1.16	2.59	4.13	0.65	0.59
August.....	¾	⅛	0.25	0.25	1½	0.10	1.22	2.66	4.13	0.60	0.58
September..	¾	⅛	0.25	0.25	1½	0.22	1.43	2.78	4.20	0.58	0.55
October.....	¾	⅛	0.29	0.31	1½	0.20	1.37	2.77	4.28	0.63	0.62
November...	¾	⅛	0.75	1.00	1½	0.14	1.29	2.73	4.18	0.57	0.55
December...	¾	⅛	0.75	1.00	1½	0.09	1.26	2.73	4.11	0.71	0.68
1936											
January.....	¾	⅛	0.75	1.00	1½	0.10	1.21	2.68	3.99	0.56	0.53
February....	¾	⅛	0.75	1.00	1½	0.08	1.15	2.62	3.90	0.55	0.53
March......	¾	⅛	0.75	1.00	1½	0.11	1.09	2.54	3.87	0.56	0.52
April.......	¾	⅛	0.75	1.00	1½	0.10	1.10	2.51	†††	0.55	0.52
May........	¾	⅛	0.93	1.17	1½	0.18	1.09	2.50	....	0.55	0.54
June.......	¾	⅛	1.00	1.25	1½	0.23	1.12	2.50	....	0.78	0.78
July........	¾	⅛– 3/16	1.00	1.25	1½	0.14	1.17	2.50	....	0.58	0.58
August.....	¾	3/16	1.00	1.25	1½	0.18	1.12	2.43	....	0.55	0.53
September..	¾	3/16	1.00	1.25	1½	0.16	1.09	2.41	....	0.55	0.53
October.....	¾	3/16	1.00	1.25	1½	0.13	1.12	2.42	....	0.56	0.54
November ..	¾	3/16	1.00	1.25	1½	0.10	0.99	2.29	....	0.56	0.55
December...	¾	3/16	1.00	1.25	1½	0.21	1.04	2.27	....	0.83	0.80

¶¶ Substituted for United States Treasury Notes and Certificates as more representative of short-term money rates.

*** Included as a measure of intermediate money rates. *Annual Report of the Board of Governors of the Federal Reserve System*, 1936, 1938, and *Federal Reserve Bulletin*. Not available prior to 1933.

††† After March, 1936, the Standard Statistics Company dropped the 15 municipal issues. For the purposes of this case book, it did not seem necessary to continue the series.

For other footnotes, *see* p. 593.

MONEY RATES—MONTHLY FIGURES, 1920 AND LATER. (*Continued*)

Month	Commercial Paper Prime 4–6 Months* New York	Bankers' Acceptances Prime 90 Days New York†	Call Loans New York Renewals‡	Time Loans New York Stock Exchange 90 Days§	Rediscount Rate Federal Reserve Bank of New York	United States Treasury Bills¶¶	United States Treasury 3–5 Year Notes***	United States Treasury Bonds¶	Bankers' Acceptances 3 Months London††	British Treasury Bills 3 Months‡‡
1937										
January	¾	3/16–¼	1.00	1.25	1½	0.36	1.18	2.47	0.56	0.54
February	¾	5/16	1.00	1.25	1½	0.38	1.22	2.46	0.55	0.53
March	¾–1	5/16–9/16	1.00	1.25	1½	0.58	1.44	2.60	0.55	0.51
April	1	9/16	1.00	1.25	1½	0.70	1.50	2.80	0.55	0.53
May	1	½–9/16	1.00	1.25	1½	0.65	1.48	2.76	0.55	0.51
June	1	7/16–½	1.00	1.25	1½	0.56	1.54	2.76	0.68	0.68
July	1	7/16	1.00	1.25	1½	0.49	1.44	2.72	0.56	0.53
August	1	7/16	1.00	1.25	1½–1	0.52	1.45	2.72	0.55	0.52
September	1	7/16	1.00	1.25	1	0.53	1.50	2.77	0.55	0.50
October	1	7/16	1.00	1.25	1	0.34	1.42	2.76	0.55	0.53
November	1	7/16	1.00	1.25	1	0.15	1.31	2.71	0.59	0.58
December	1	7/16	1.00	1.25	1	0.10	1.27	2.67	0.75	0.71
1938										
January	1	7/16	1.00	1.25	1	0.10	1.13	2.65	0.54	0.51
February	1	7/16	1.00	1.25	1	0.08	1.09	2.64	0.53	0.50
March	¾–1	7/16	1.00	1.25	1	0.07	1.01	2.64	0.53	0.50
April	¾–1	7/16	1.00	1.25	1	0.08	0.94	2.62	0.53	0.51
May	¾–1	7/16	1.00	1.25	1	0.03	0.77	2.51	0.53	0.51
June	¾–1	7/16	1.00	1.25	1	0.02	0.67	2.52	0.59	0.59
July	¾	7/16	1.00	1.25	1	0.05	0.70	2.52	0.65	0.52
August	¾	7/16	1.00	1.25	1	0.05	0.71	2.51	0.53	0.51
September	⅝–¾	7/16	1.00	1.25	1	0.10	0.82	2.58	0.91	0.86
October	⅝–¾	7/16	1.00	1.25	1	0.02	0.68	2.48	0.70	0.68
November	⅝–¾	7/16	1.00	1.25	1	0.02	0.71	2.50	0.66	0.67
December	⅝	7/16	1.00	1.25	1	0.01	0.67	2.49	0.96	0.93
1939										
January	½–⅝	7/16	1.00	1.25	1	0.002	0.65	2.47	0.55	0.53
February	½–⅝	7/16	1.00	1.25	1	0.004	0.63	2.44	0.53	0.51
March	½–⅝	7/16	1.00	1.25	1	0.005	0.51	2.34	0.63	0.70
April	½–⅝	7/16	1.00	1.25	1	0.019	0.50	2.30	1.40	1.36
May	½–⅝	7/16	1.00	1.25	1	0.006	0.42	2.17	0.73	0.70
June	½–⅝	7/16	1.00	1.25	1	0.006	0.39	2.13	0.75	0.76
July	½–⅝	7/16	1.00	1.25	1	0.017	0.45	2.16	0.79	0.77
August	½–⅝	7/16	1.00	1.25	1	0.046	0.48	2.21	1.58	1.92
September	⅝–¾	7/16	1.00	1.25	1	0.102	1.07	2.65	3.51	3.23
October	⅝–¾	7/16	1.00	1.25	1	0.028	0.77	2.60	1.88	1.77
November	½–¾	7/16	1.00	1.25	1	0.018	0.64	2.46	1.96	1.18
December	½–⅝	7/16	1.00	1.25	1	0.012	0.51	2.35	1.23	1.24

For footnotes, see pp. 593, 597.

APPENDIX IV

SAFEGUARDING DEVICES FOR CREDIT[1]

In order to make credit, which in the main is supported by the possibility of suing at law and obtaining a judgment, more secure, modern law has developed three types of supplementary methods.

These methods may be called, for convenience, (I) personal security, (II) real security, and (III) security through control.

I. By *personal security* is meant any method of bringing in an additional person to whom recourse may be had if the principal debtor cannot, or in any event does not, pay his debt. This end is accomplished in general by inducing the additional person to enter into a contract, subject to the ordinary laws of contract, obliging him to pay either absolutely or conditionally. Thus, the second promisor may make a promise that he will pay the debt if the principal debtor is insolvent (*guaranty of solvency*), or if the principal debtor whether solvent or not fails to pay (*guaranty of payment*). By *endorsing* the note of the principal debtor he may assume the position of a guarantor subject to the series of conditions described in the Negotiable Instruments Law, the most important of which are that the holder will make the proper effort to collect the note from the principal debtor at the proper time and place, and notify the endorser in the proper manner of the dishonor of the note for nonpayment. Again, the contract may have little or no direct reference to the particular debt, but may assume the guise of an independent contract to make good any loss suffered by the creditor through the failure of the debtor (*indemnity*). Of course the person on whose credit chief reliance is made may make the contract in such a way as to be the one *primarily liable* on it in law, instead of merely *secondarily* liable, or he may join in the original contract so as to appear equally liable from the beginning with the principal contractor (*suretyship*). A

[1] This summary was prepared, upon request, by Nathan Isaacs and Francis N. Balch, to provide merely a concise survey of the numerous methods available to lenders.

peculiar position may be assumed by an agent by virtue of which he may be charged back with goods sold on behalf of his principal and charged in the first instance by the principal to the buyer (*del credere agency*).

II. *Real security* is effected by giving the creditor a hold on or recourse to a thing. This hold may be of two kinds: (A) through the incumbrance in some manner of the borrower's title, and (B) through actual physical interference with his possession of his goods.

(A) Mere title hold is of course preferable from the point of view of the borrower who wishes to use the thing on the basis of which credit is received while enjoying the credit. It is more complicated, however, in that it calls for the use of more delicate legal machinery for the balancing of the interests of the parties concerned as well as those of the innocent stranger. The incumbrance on the title of the borrower may, but need not, go the whole length of placing (or leaving) the title for the time being in the lender as in the traditional *real estate mortgage*, *chattel mortgage*, *conditional sale*, *bailment receipt*, *lease with privilege of purchase*, and assignment of "*choses in action*" or intangible rights. It is more likely, however, merely to interfere with the power of the borrower to sell or control the property in question until the debt is paid, as in the statutory liens on real estate given to laborers, materialmen, contractors, and subcontractors (*mechanics' liens*), or in the process of exacting from the debtor the obligations of a trustee with reference to the goods, or proceeds of goods ("*trust receipts*," so-called). In connection with many of these devices it has been found desirable to make some arrangement for public notice, or at least record, of the otherwise secret liens, to prevent a conflict of claims between the creditor and innocent purchasers for value without notice.

(B) The simpler process of transferring possession without title (or possession and title together) to the lender is illustrated in the pledge of tangible things (*pawns*), or of symbols of intangible rights, such as stocks, bonds, or documents of title (*collateral security*). In general, such *possessory liens* give the right to withhold possession, coupled nowadays with some power of converting the thing into cash if certain conditions are broken, until the lienor is paid for his service in connection with a thing. Some of them are relics of the old law of self-help, but by far the greater part are modern contractual revivals and extensions of the same idea.

Sometimes the possession of the thing is handed over to a trusted person with instructions to hand it on or turn it back, depending upon whether certain conditions, such as the payment of money, are fulfilled (*escrow*).

III. *Security through control* over a debtor's affairs or his goods may be obtained by methods as unlimited in number as human ingenuity itself. The creditor may be satisfied with a position on the board of directors of the borrowing corporation, he may demand an arrangement whereby his signature is necessary on the checks of the borrower, or he may stipulate for some other type of interest in the borrowing business. In addition, there are various types of modifications of procedural law that tend to remove the dangers or delays incident to ordinary legal procedure. Among these are the power to confess judgment, sometimes added to a promissory note or other document, and the waiver of exemptions. Voting power is sometimes included in bonds which are really evidences of indebtedness; but even stock, particularly preferred stock, may in the final analysis represent in fact credit extended with a power of control for security, rather than the actual ownership of a share in a business which legal theory declares it to be.

APPENDIX V

RESERVE BANK CREDIT OUTSTANDING AND FACTORS IN CHANGES, BY MONTHS, JANUARY, 1918, TO DECEMBER, 1932, INCLUSIVE*

(Averages of daily figures. In millions of dollars)

	Reserve Bank Credit Outstanding					Factors of Decrease		Factors of Increase			
	Bills Discounted	Bills Bought	United States Securities	Other Reserve Bank Credit†	Total	Monetary Gold Stock	Treasury Currency (adjusted)	Money in Circulation	Member Bank Reserve Balances	Non-member Deposits, Etc.	Unexpended Capital Funds
1918											
January	612	266	149	143	1,170	3,152	1,563	4,306	1,467	36	76
February	529	288	185	141	1,143	3,159	1,589	4,280	1,468	63	80
March	537	315	271	140	1,263	3,162	1,583	4,373	1,466	85	84
April	751	313	173	144	1,381	3,163	1,563	4,423	1,504	95	85
May	897	278	86	151	1,412	3,163	1,521	4,401	1,482	126	87
June	939	239	97	279	1,554	3,162	1,471	4,448	1,512	138	89
July	1,162	208	65	196	1,631	3,161	1,392	4,520	1,448	124	92
August	1,333	217	53	147	1,750	3,157	1,439	4,666	1,459	126	95
September	1,604	249	67	153	2,073	3,156	1,411	4,911	1,507	121	101
October	1,683	354	123	195	2,355	3,151	1,402	5,134	1,539	130	105
November	1,760	374	130	152	2,416	3,155	1,378	5,183	1,520	131	115
December	1,765	346	214	166	2,491	3,156	1,418	5,243	1,586	117	119
1919											
January	1,731	278	200	150	2,359	3,160	1,400	5,050	1,635	118	116
February	1,765	274	186	116	2,341	3,162	1,286	4,932	1,612	114	131
March	1,863	261	195	161	2,480	3,161	1,207	4,942	1,652	123	131
April	1,920	207	213	111	2,451	3,166	1,277	4,970	1,656	126	142
May	1,976	187	228	107	2,408	3,176	1,233	4,941	1,686	135	145
June	1,840	247	236	144	2,467	3,169	1,231	4,801	1,690	133	147
July	1,864	358	249	128	2,599	3,087	1,207	4,896	1,710	121	157
August	1,798	372	270	110	2,550	3,114	1,248	4,913	1,740	104	164
September	1,776	351	341	168	2,636	3,143	1,254	4,930	1,769	108	167
October	2,068	343	296	140	2,847	3,120	1,209	5,106	1,793	90	173
November	2,140	455	307	136	3,038	3,070	1,230	5,208	1,837	97	196
December	2,115	549	327	212	3,203	3,021	1,239	5,342	1,820	100	201
1920											
January	2,136	570	326	173	3,205	2,961	1,256	5,231	1,883	98	210
February	2,297	541	309	167	3,314	2,909	1,241	5,285	1,858	94	227
March	2,377	480	344	212	3,413	2,859	1,338	5,398	1,878	98	236
April	2,431	413	332	188	3,364	2,821	1,409	5,372	1,870	106	246

1920 (*Continued*)											
May	2,536	411	302	136	3,385	2,835	1,412	5,414	1,853	103	262
June	2,456	400	347	179	3,382	2,854	1,426	5,448	1,853	88	273
July	2,513	362	319	150	3,344	2,862	1,454	5,478	1,840	54	288
August	2,596	324	304	129	3,353	2,855	1,456	5,509	1,807	46	302
September	2,667	310	339	179	3,495	2,847	1,429	5,600	1,817	38	316
October	2,780	303	305	134	3,522	2,855	1,468	5,673	1,815	27	330
November	2,762	276	320	109	3,467	2,873	1,475	5,662	1,782	27	344
December	2,718	242	339	143	3,442	2,894	1,458	5,658	1,758	25	353
1921											
January	2,523	200	298	89	3,110	2,931	1,463	5,401	1,773	24	306
February	2,400	169	287	62	2,918	2,975	1,435	5,263	1,728	26	311
March	2,297	137	296	68	2,798	3,040	1,411	5,204	1,694	31	321
April	2,129	110	277	48	2,564	3,117	1,427	5,078	1,665	34	331
May	1,959	84	303	40	2,386	3,197	1,485	5,042	1,657	32	337
June	1,811	54	302	44	2,211	3,254	1,508	4,936	1,664	31	342
July	1,719	26	261	43	2,049	3,305	1,513	4,857	1,639	27	344
August	1,548	38	249	28	1,863	3,392	1,508	4,771	1,621	26	345
September	1,442	40	254	31	1,767	3,479	1,510	4,752	1,629	27	348
October	1,371	56	207	35	1,669	3,547	1,534	4,721	1,652	26	351
November	1,228	79	208	29	1,544	3,595	1,575	4,673	1,663	28	350
December	1,180	105	226	37	1,548	3,643	1,577	4,718	1,673	27	350
1922											
January	962	98	238	28	1,326	3,672	1,551	4,527	1,707	29	286
February	769	88	357	19	1,233	3,704	1,521	4,451	1,689	34	284
March	638	92	459	18	1,207	3,736	1,576	4,483	1,711	39	286
April	572	93	520	25	1,210	3,756	1,572	4,482	1,733	40	283
May	479	103	603	23	1,208	3,768	1,576	4,450	1,783	37	282
June	437	136	591	28	1,192	3,776	1,600	4,429	1,820	34	285
July	425	153	547	45	1,170	3,803	1,595	4,443	1,612	28	285
August	396	159	497	50	1,102	3,840	1,613	4,448	1,799	25	283
September	417	212	486	65	1,180	3,860	1,630	4,552	1,811	23	284
October	486	252	448	60	1,246	3,884	1,657	4,643	1,836	21	287
November	623	260	325	57	1,265	3,896	1,650	4,671	1,825	27	288
December	660	259	380	78	1,377	3,917	1,690	4,827	1,840	28	289
1923											
January	547	218	421	63	1,249	3,945	1,724	4,679	1,918	46	275
February	608	190	356	51	1,205	3,960	1,709	4,672	1,901	25	276
March	628	234	316	50	1,228	3,966	1,690	4,713	1,873	22	276
April	658	272	229	55	1,214	3,975	1,711	4,731	1,869	21	279
May	705	271	193	53	1,222	3,993	1,740	4,764	1,874	36	281
June	741	224	153	60	1,178	4,040	1,738	4,779	1,867	28	282
July	834	186	97	62	1,179	4,061	1,743	4,812	1,867	24	280
August	809	175	90	53	1,127	4,097	1,747	4,833	1,835	22	281

* Sources: *Annual Report of the Federal Reserve Board*, 1930, 1933, 1936, 1938, and *Federal Reserve Bulletin*. For an explanation of each item, see *Federal Reserve Bulletin*, July, 1929, pp. 432–433. See also subsequent footnotes.

For an excellent illustration of the use of these figures in analyzing money market changes, see Burgess, W. R., "Progress of Money Market Statistics," *Journal of American Statistical Association*, March, 1931, *Supplement*, especially pp. 153–154.

† Includes government overdrafts in 1918, 1919, and 1920.

RESERVE BANK CREDIT OUTSTANDING AND FACTORS IN CHANGES, BY MONTHS, JANUARY, 1918, TO DECEMBER, 1932, INCLUSIVE. *(Continued)*

(Averages of daily figures. In millions of dollars)

	Reserve Bank Credit Outstanding					Factors of Decrease		Factors of Increase			
	Bills Discounted	Bills Bought	United States Securities	Other Reserve Bank Credit	Total	Monetary Gold Stock	Treasury Currency (adjusted)	Money in Circulation	Member Bank Reserve Balances	Non-member Deposits, Etc.	Unexpended Capital Funds
1923 *(Continued)*											
September	845	174	102	63	1,184	4,123	1,745	4,901	1,848	22	281
October	873	185	91	55	1,204	4,155	1,753	4,941	1,864	23	284
November	799	265	83	57	1,204	4,182	1,757	4,953	1,875	31	284
December	771	324	106	59	1,260	4,226	1,771	5,071	1,882	22	282
1924											
January	574	300	118	49	1,041	4,266	1,750	4,847	1,911	25	274
February	514	273	135	33	955	4,302	1,759	4,832	1,892	22	270
March	476	228	244	42	990	4,340	1,747	4,870	1,915	22	270
April	489	170	274	48	981	4,383	1,720	4,886	1,905	23	270
May	433	80	324	42	879	4,433	1,766	4,866	1,922	24	266
June	370	50	416	50	886	4,471	1,759	4,830	2,001	21	264
July	315	44	467	53	879	4,503	1,763	4,810	2,046	28	261
August	268	30	539	44	881	4,516	1,763	4,800	2,072	33	255
September	262	92	575	54	983	4,515	1,763	4,853	2,120	31	257
October	240	180	585	52	1,057	4,506	1,755	4,891	2,141	27	259
November	228	268	588	51	1,135	4,517	1,771	4,970	2,164	30	259
December	301	358	554	75	1,288	4,507	1,768	5,088	2,182	32	261
1925											
January	267	329	464	65	1,125	4,468	1,765	4,863	2,194	43	258
February	340	314	384	56	1,094	4,392	1,778	4,805	2,150	42	258
March	390	298	376	58	1,122	4,340	1,782	4,814	2,137	30	263
April	403	287	355	65	1,110	4,340	1,769	4,803	2,123	27	266
May	397	279	361	63	1,100	4,353	1,762	4,791	2,132	28	264
June	437	263	345	73	1,118	4,360	1,744	4,790	2,141	25	266
July	480	231	338	69	1,118	4,361	1,764	4,794	2,160	27	262
August	545	205	329	64	1,143	4,372	1,742	4,817	2,151	25	264
September	594	226	335	72	1,227	4,386	1,749	4,908	2,161	26	267
October	619	298	328	76	1,321	4,391	1,737	4,945	2,203	30	271
November	597	352	332	71	1,352	4,407	1,735	4,960	2,221	41	272
December	688	369	359	91	1,507	4,397	1,740	5,119	2,219	32	274
1926											
January	520	324	368	67	1,279	4,407	1,744	4,891	2,236	30	273
February	526	305	335	52	1,218	4,425	1,719	4,854	2,208	26	274

1926 (Continued)											
March	557	268	336	55	1,216	4,444	1,707	4,864	2,198	27	278
April	537	234	371	62	1,204	4,448	1,722	4,882	2,183	26	283
May	511	232	398	59	1,200	4,434	1,744	4,871	2,199	26	282
June	473	243	408	61	1,185	4,438	1,771	4,881	2,206	23	284
July	549	230	380	62	1,221	4,460	1,753	4,916	2,212	25	281
August	555	245	353	50	1,203	4,467	1,755	4,912	2,201	27	285
September	640	265	316	57	1,278	4,471	1,750	4,969	2,211	30	289
October	663	295	306	58	1,322	4,472	1,746	5,001	2,219	27	293
November	615	348	302	53	1,318	4,477	1,755	5,005	2,214	36	295
December	668	385	322	70	1,445	4,481	1,749	5,131	2,218	32	294
1927											
January	481	343	310	52	1,186	4,527	1,760	4,903	2,243	33	294
February	393	304	307	39	1,043	4,576	1,757	4,843	2,212	26	295
March	425	253	345	32	1,055	4,595	1,767	4,856	2,240	23	298
April	447	248	341	51	1,087	4,601	1,761	4,879	2,248	23	299
May	473	233	291	44	1,041	4,651	1,768	4,860	2,262	39	299
June	429	205	398	49	1,081	4,606	1,777	4,831	2,301	34	298
July	454	190	381	90	1,115	4,575	1,780	4,851	2,289	33	297
August	409	173	439	72	1,093	4,585	1,780	4,849	2,283	30	296
September	422	216	501	48	1,187	4,584	1,776	4,917	2,300	30	300
October	424	282	506	42	1,254	4,566	1,776	4,934	2,326	34	302
November	415	336	579	47	1,377	4,490	1,790	4,936	2,373	44	304
December	529	378	606	55	1,568	4,416	1,796	5,048	2,399	27	306
1928											
January	465	373	512	38	1,388	4,377	1,778	4,785	2,426	27	305
February	471	360	406	27	1,264	4,373	1,776	4,709	2,368	26	310
March	513	343	415	24	1,295	4,335	1,781	4,710	2,365	24	312
April	661	358	351	35	1,405	4,287	1,778	4,730	2,396	27	317
May	836	349	257	30	1,472	4,207	1,779	4,722	2,388	27	321
June	1,019	244	232	36	1,531	4,119	1,791	4,736	2,355	28	322
July	1,090	185	213	43	1,531	4,113	1,782	4,746	2,324	30	326
August	1,061	178	210	36	1,485	4,118	1,774	4,743	2,274	28	332
September	1,064	226	240	51	1,581	4,125	1,787	4,804	2,314	38	337
October	975	368	237	41	1,621	4,133	1,786	4,836	2,332	30	342
November	897	471	238	47	1,653	4,151	1,787	4,860	2,352	32	347
December	1,013	483	263	65	1,824	4,142	1,790	5,008	2,367	29	352
1929											
January	859	473	229	52	1,613	4,115	1,789	4,748	2,387	31	351
February	889	385	184	44	1,502	4,143	1,784	4,686	2,357	29	357
March	969	265	197	50	1,481	4,166	1,791	4,709	2,337	31	361
April	1,004	156	165	52	1,377	4,226	1,785	4,679	2,308	35	366
May	956	145	153	49	1,303	4,292	1,787	4,684	2,296	32	370
June	978	99	179	61	1,317	4,311	1,779	4,687	2,314	30	376

RESERVE BANK CREDIT OUTSTANDING AND FACTORS IN CHANGES, BY MONTHS, JANUARY, 1918, TO DECEMBER, 1932, INCLUSIVE. *Continued)*
(Averages of daily figures. In millions of dollars)

	Reserve Bank Credit Outstanding					Factors of Decrease		Factors of Increase			
	Bills Discounted	Bills Bought	United States Securities	Other Reserve Bank Credit	Total	Monetary Gold Stock	Treasury Currency adjusted	Money in Circulation	Member Bank Reserve Balances	Non-member Deposits, Etc.	Unexpended Capital Funds
1929 *(Continued)*											
July	1,096	75	147	62	1,380	4,335	1,700	4,764	2,334	31	376
August	1,043	124	155	54	1,376	4,351	1,731	4,777	2,322	27	382
September	969	229	165	64	1,427	4,368	1,766	4,311	2,335	28	387
October	885	337	154	74	1,450	4,381	1,735	4,810	2,386	25	392
November	953	296	315	67	1,631	4,374	1,780	4,345	2,521	33	395
December	803	320	446	74	1,643	4,324	1,797	4,943	2,395	27	399
1930											
January	501	314	485	57	1,357	4,282	1,734	4,652	2,340	29	393
February	378	285	480	38	1,181	4,317	1,781	4,554	2,305	27	393
March	274	246	540	35	1,095	4,394	1,707	4,532	2,330	27	397
April	231	266	530	45	1,072	4,443	1,731	4,518	2,350	28	400
May	247	182	529	38	999	4,505	1,779	4,407	2,356	29	398
June	251	141	571	37	1,000	4,518	1,775	4,480	2,392	27	395
July	226	154	583	40	1,003	4,532	1,789	4,483	2,417	35	389
August	214	153	599	32	923	4,526	1,787	4,476	2,392	28	385
September	180	197	597	33	1,016	4,593	1,785	4,492	2,397	26	380
October	196	185	602	37	1,020	4,520	1,787	4,591	2,407	27	392
November	221	184	599	29	1,033	4,553	1,793	4,528	2,433	30	388
December	338	257	644	34	1,273	4,583	1,793	4,823	2,415	27	384
1931											
January	253	206	647	23	1,129	4,622	1,784	4,605	2,433	28	370
February	216	102	603	15	936	4,656	1,780	4,598	2,370	25	379
March	176	123	604	18	921	4,682	1,778	4,590	2,386	24	381
April	155	173	600	24	952	4,711	1,770	4,647	2,376	27	383
May	163	144	599	20	926	4,767	1,783	4,679	2,387	28	382
June	188	121	610	26	945	4,865	1,759	4,750	2,404	35	380

1931 (*Continued*)											
July	169	79	674	32	954	4,958	1,784	4,836	2,407	83	370
August	222	135	712	38	1,107	4,975	1,764	4,947	2,345	187	367
September	280	259	736	38	1,313	4,948	1,768	5,133	2,333	199	364
October	613	692	733	50	2,088	4,447	1,768	5,478	2,256	208	361
November	695	560	727	53	2,035	4,363	1,766	5,518	2,118	171	357
December	774	340	777	59	1,950	4,450	1,782	5,611	2,069	144	358
1932											
January	828	221	759	56	1,864	4,452	1,773	5,645	1,979	113	352
February	848	151	743	43	1,785	4,384	1,787	5,627	1,907	73	349
March	714	105	809	24	1,652	4,372	1,792	5,531	1,899	37	349
April	605	52	1,014	23	1,694	4,381	1,780	5,452	1,996	63	353
May	486	41	1,413	19	1,960	4,273	1,788	5,456	2,138	77	349
June	495	50	1,697	20	2,262	3,956	1,787	5,530	2,062	65	348
July	523	60	1,818	21	2,422	3,941	1,780	5,751	2,003	46	343
August	451	37	1,850	15	2,353	4,030	1,796	5,719	2,073	40	347
September	387	34	1,848	13	2,282	4,140	1,826	5,685	2,181	35	347
October	328	34	1,851	18	2,231	4,226	1,886	5,643	2,307	38	355
November	313	34	1,851	13	2,211	4,292	1,917	5,643	2,378	40	359
December	282	34	1,854	22	2,192	4,429	1,915	5,699	2,435	43	359

APPENDIX Va*

FEDERAL RESERVE BANK CREDIT OUTSTANDING AND RELATED ITEMS

(Averages of daily figures. In millions of dollars)

	Reserve Bank Credit Outstanding					Gold Stock	Treasury Currency Outstanding	Money in Circulation	Treasury Cash Holdings	Treasury Deposits with Federal Reserve Banks	Nonmember Deposits	Other Federal Reserve Accounts	Member Bank Reserves	
	Bills Discounted	Bills Bought	United States Government Securities	Other Reserve Bank Credit	Total								Total	Excess
1933														
January	255	32	1,806	16	2,110	4,260	2,204	5,344	276	27	60	351	2,516	584
February	307	102	1,804	12	2,224	4,204	2,204	5,605	277	37	79	343	2,291	417
March	999	379	1,875	15	3,237	3,974	2,256	6,711	303	56	134	349	1,914	†
April	429	230	1,837	18	2,515	4,014	2,302	5,850	350	40	156	349	2,086	379
May	339	86	1,846	15	2,286	4,026	2,301	5,589	323	48	173	355	2,125	319
June	250	12	1,933	12	2,208	4,030	2,205	5,455	272	81	164	350	2,211	363
July	170	16	2,016	10	2,211	4,032	2,283	5,388	274	73	179	344	2,268	436
August	159	8	2,064	8	2,239	4,036	2,280	5,329	271	45	186	349	2,375	566
September	138	7	2,202	12	2,358	4,040	2,280	5,345	272	56	169	347	2,489	675
October	119	7	2,355	11	2,492	4,037	2,277	5,369	273	60	163	351	2,500	758
November	114	15	2,437	8	2,574	4,036	2,275	5,304	281	68	158	355	2,629	794
December	117	101	2,432	19	2,669	4,036	2,293	5,524	286	71	143	358	2,616	766
1934														
January	101	113	2,432	9	2,656	4,036	2,302	5,382	300	88	146	304	2,764	866
February	70	87	2,432	8	2,597	7,138	2,303	5,339	3,368	80	136	203	2,822	801
March	55	40	2,437	3	2,535	7,602	2,333	5,368	3,256	42	144	208	3,301	1,375
April	43	16	2,439	9	2,507	7,736	2,377	5,366	3,167	55	170	268	3,594	1,541
May	36	6	2,431	6	2,479	7,759	2,378	5,355	3,020	63	240	234	3,695	1,623
June	28	5	2,424	7	2,464	7,821	2,363	5,341	2,939	115	226	237	3,700	1,685
July	23	5	2,432	9	2,469	7,803	2,364	5,350	2,040	50	210	230	3,928	1,780
August	21	5	2,432	6	2,463	7,971	2,378	5,355	2,020	56	208	228	4,045	1,884
September	22	5	2,431	10	2,469	7,971	2,411	5,427	2,915	139	197	227	3,947	1,754
October	13	6	2,430	8	2,457	7,989	2,415	5,473	2,020	91	177	234	3,964	1,731
November	18	6	2,430	12	2,466	8,047	2,455	5,404	2,925	45	165	238	4,100	1,834
December	10	6	2,430	26	2,472	8,191	2,494	5,577	2,983	137	181	242	4,037	1,748
1935														
January	8	6	2,430	21	2,465	8,284	2,504	5,411	2,980	73	104	242	4,355	2,035
February	6	6	2,430	20	2,462	8,465	2,513	5,439	2,910	55	189	246	4,601	2,237

1935 (*Continued*)														
March	7	5	2,431	18	2,461	8,552	2,526	5,477	2,920	202	236	250	4,452	2,065
April	6	5	2,431	29	2,471	8,641	2,548	5,500	2,938	271	258	256	4,436	2,026
May	7	5	2,434	30	2,476	8,755	2,534	5,507	2,882	60	278	259	4,778	2,297
June	8	5	2,431	36	2,479	9,025	2,513	5,522	2,008	81	266	260	4,979	2,438
July	7	5	2,430	30	2,473	9,128	2,504	5,550	2,839	193	293	259	4,970	2,385
August	7	5	2,431	33	2,476	9,180	2,441	5,576	2,729	66	233	261	5,232	2,636
September	10	5	2,430	35	2,480	9,246	2,389	5,651	2,632	102	236	252	5,243	2,628
October	8	5	2,430	39	2,482	9,545	2,398	5,704	2,638	55	307	253	5,469	2,820
November	7	5	2,430	40	2,482	9,777	2,410	5,770	2,581	49	256	256	5,757	3,061
December	6	5	2,430	53	2,494	10,072	2,454	5,897	2,545	324	267	263	5,716	2,983
1936														
January	6	5	2,430	43	2,484	10,158	2,486	5,757	2,564	494	280	253	5,780	3,033
February	8	5	2,430	50	2,493	10,164	2,495	5,779	2,515	466	329	255	5,808	3,038
March	6	5	2,430	43	2,484	10,172	2,502	5,857	2,518	760	336	267	5,420	2,653
April	6	5	2,430	39	2,480	10,202	2,503	5,892	2,539	845	348	260	5,300	2,510
May	5	4	2,430	37	2,476	10,324	2,495	5,918	2,574	559	258	348	5,638	2,800
June	6	3	2,430	39	2,478	10,514	2,492	6,062	2,579	793	289	278	5,484	2,593
July	3	3	2,430	37	2,474	10,629	2,497	6,203	2,453	545	281	255	5,861	2,907
August	6	3	2,430	35	2,474	10,674	2,499	6,191	2,416	275	328	256	6,181	2,458
September	8	3	2,430	38	2,479	10,764	2,507	6,258	2,386	233	260	268	6,345	1,852
October	7	3	2,430	40	2,480	10,983	2,512	6,321	2,413	146	239	263	6,594	2,043
November	6	3	2,430	33	2,472	11,116	2,517	6,401	2,373	86	199	262	6,785	2,219
December	7	3	2,434	54	2,498	11,220	2,528	6,563	2,357	155	238	268	6,665	2,046
1937														
January	3	3	2,430	48	2,485	11,310	2,531	6,400	2,450	200	300	260	6,716	2,093
February	3	3	2,431	38	2,475	11,399	2,531	6,369	2,569	167	296	258	6,747	2,152
March	6	3	2,432	31	2,472	11,503	2,537	6,391	2,682	205	273	257	6,704	1,371
April	10	4	2,480	29	2,522	11,686	2,541	6,397	2,863	159	248	258	6,824	1,552
May	16	5	2,526	30	2,577	11,901	2,546	6,426	3,069	85	255	256	6,932	927
June	15	5	2,526	32	2,578	12,189	2,548	6,435	3,322	131	290	259	6,878	876
July	13	3	2,526	31	2,574	12,404	2,555	6,475	3,532	137	285	258	6,845	876
August	17	3	2,527	26	2,573	12,512	2,576	6,500	3,655	212	334	258	6,701	750
September	24	3	2,526	30	2,584	12,653	2,590	6,558	3,618	190	345	262	6,854	900
October	22	3	2,527	31	2,583	12,782	2,603	6,566	3,636	95	452	265	6,954	1,043
November	19	3	2,545	25	2,592	12,788	2,613	6,558	3,642	125	488	262	6,919	1,104
December	16	3	2,565	44	2,628	12,765	2,627	6,618	3,622	188	447	266	6,879	1,071
1938														
January	11	1	2,564	38	2,602	12,756	2,643	6,397	3,630	127	403	261	7,183	1,353
February	11	1	2,564	34	2,598	12,768	2,662	6,319	3,630	164	426	259	7,230	1,406
March	10	1	2,565	32	2,597	12,778	2,673	6,338	3,558	221	346	259	7,326	1,524
April	11	1	2,569	37	2,606	12,829	2,685	6,387	2,769	900	334	260	7,469	2,071
May	8	1	2,564	30	2,594	12,891	2,697	6,415	2,227	1,315	376	261	7,587	2,525
June	9	1	2,560	32	2,592	12,946	2,707	6,433	2,283	967	420	263	7,878	2,762
July	8	1	2,564	35	2,599	12,985	2,716	6,464	2,318	717	374	260	8,167	3,026

For footnotes see p. 610.

FEDERAL RESERVE BANK CREDIT OUTSTANDING AND RELATED ITEMS. (Continued)

	Reserve Bank Credit Outstanding					Gold Stock	Treasury Currency Outstanding	Money in Circulation	Treasury Cash Holdings	Treasury Deposits with Federal Reserve Banks	Nonmember Deposits	Other Federal Reserve Accounts	Member Bank Reserves	
	Bills Discounted	Bills Bought	United States Government Securities	Other Reserve Bank Credit	Total								Total	Excess
1938 (Continued)														
August	7	1	2,564	26	2,500	13,057	2,724	6,482	2,392	704	350	256	8,110	2,955
September	8	1	2,572	30	2,610	13,441	2,733	6,570	2,717	704	340	258	8,106	2,920
October	8	1	2,564	26	2,598	13,940	2,745	6,668	2,782	605	361	261	8,546	3,143
November	7	1	2,564	20	2,592	14,162	2,760	6,750	2,728	526	524	259	8,727	3,270
December	7	1	2,564	47	2,618	14,416	2,783	6,888	2,673	723	526	263	8,745	3,226
1939														
January	5	1	2,568	24	2,598	14,500	2,807	6,712	2,726	827	454	257	9,029	3,484
February	5	1	2,567	21	2,594	14,778	2,820	6,607	2,758	1,055	502	255	8,025	3,373
March	3	1	2,567	23	2,590	15,014	2,832	6,764	2,720	1,155	510	259	9,021	3,432
April	3	1	2,567	20	2,593	15,500	2,814	6,807	2,703	1,001	495	256	9,624	3,026
May	4	1	2,564	18	2,582	15,878	2,856	6,910	2,663	926	557	255	9,007	4,212
June	4	1	2,563	28	2,591	16,028	2,870	6,966	2,568	929	682	258	10,085	4,246
July	5	1	2,527	42	2,569	16,182	2,837	7,051	2,534	780	695	257	10,321	4,402
August	5	1	2,437	30	2,467	16,300	2,900	7,008	2,344	783	616	256	10,659	4,607
September	6	1	2,732	56	2,794	16,823	2,911	7,240	2,253	611	720	243	11,443	5,198
October	6	.	2,763	63	2,832	17,002	2,926	7,328	2,239	358	732	240	11,862	5,490
November	7	.	2,651	63	2,722	17,217	2,930	7,413	2,314	454	760	241	11,688	5,259
December	8	.	2,510	94	2,612	17,518	2,955	7,609	2,402	616	730	248	11,473	5,011

* Note changes in headings from Appendix V. For explanation, see *Federal Reserve Bulletin*, July, 1935, pp. 419–429.
† No figure.

APPENDIX VI

ILLUSTRATIONS OF THE VARIETY OF TREATMENT AFFORDED BY THE CASE METHOD

In the case of the Charles National Bank, some students elected to consider the problem as one of historical review in order to criticize and evaluate the decisions made. Other students thought it more realistic to accept the decisions made and to outline a policy for future administrative action. Samples of such student reactions are reproduced herewith. They are offered without material emendation and without approval in detail. The purpose of this presentation is merely to show students and teachers that a variety of approaches is possible and that there need not be only one solution to any given case.

These samples were taken from final examination papers written by students who had not theretofore seen the Charles National Bank case.

I

The purpose of this paper is to gauge the fairness of the exchange and to make an estimate of the claims and policies of Bankshares after acquiring control of Charles.

1. The minimum price is the liquidating value. The balance sheet for June 30, 1930, is taken, since that for December 31, 1930, probably reflects certain write-offs resulting from audit and suggestions received from Bankshares. Let us write off 25% (liberal) Other Bonds and Securities, or $100,000; 10% Loans and Discounts, or $1,000,000; 50% Real Estate, etc., or $100,000; total $1,200,000. This leaves *$150,000 net worth.* To this we should add value of deposits, or, at 3% (somewhat low for this size bank, but this fact is offset by low quality of some of deposits) $450,000. The liquidating value, hence, is $600,-000, or $60 per share . . . no allowance being made for cost of liquidation. Comparing this with the market value of Bankshares, exchange would be about on a 5 to 1 basis. This is an absolute minimum exchange value since the bank is a going concern.

2. On the basis of market value, the exchange would be on a 10 to 1 basis . . . Market value seldom reflects fair or true value. Besides, the marketability of Charles shares is probably very limited, so we have a poor basis for fixing market value on the bank's side of the exchange.

3. On the basis of book value, an exchange would again be on a 10 to 1 basis. This measure is objectionable since book value is readily subject to manipulation, and even if not manipulated is hardly comparable if the parties to the exchange are using different account systems. With the evidence on hand, I would not rely upon it.

4. The capitalization of earnings method is objectionable here, since we have too short a period of history. *Future earnings possibilities* are really the crux of the question. However, comparing earnings of Charles for the first six months of 1930 with Bankshares earnings for 1930, we have on the basis of the same capitalization (which may not be quite fair) an exchange ratio of 8 to 1.

The ratios of exchange given above are only guide posts. The exchange value hinges primarily on the bargaining power of the parties. The value arrived at should essentially reflect future earnings.

Whether the president of Charles was wise to sell, from his own selfish standpoint, depends on the amount of stock he held and his beliefs about the future of the business, or on his limitations in ability to analyze the situation and reap the benefits of the rapid growth of the bank. For instance, if he was old and wished to retire and place his money in a safer place, I believe he was wise to sell out provided he, in turn, got rid of his Bankshares and bought a diversified lot of relatively safe securities.

Bankshares, in view of the possibilities of improving the already fair earnings of the bank (judging from June 30, 1930, statement) "made a good buy."

I believe that the Charles stockholders, other than the president and possibly some of the officers who may have found good reasons to sell out (retirement, lack of ability, etc.) missed a good "bet" if they were in a position to change the management. A new president with the right "stuff" in him could have done substantially everything for the bank that Bankshares could do and certainly at a much lower cost. A bank is no better than its management, and the main trouble with the American banking system is, in my opinion, the lack of real, good, *progressive* bankers. With the right man, earnings could have been improved and the stockholders would have reaped the whole benefit themselves instead of sharing it with others and actually *taking a lower return* on their investment. This lower return certainly is not for safety! There is plenty of "water" in Bankshares. Group banking is no better than its poorest link, although a *good* holding company may often, through good management, save a bank from ruin. Thus, stockholders should, if possible, have changed management and reaped the benefits themselves.

It has been said that Charles was a good "buy" even though past earnings did *not quite* come up to the consolidated earnings of the Bankshares group. My reason for making this statement is that prospects for improved net earnings appeared excellent.

Deposits.—The ratio of deposits to net worth is rather large and indicates too rapid growth. Hence, I believe the bank should ease down on the "get new business" campaign and concentrate efforts on

the best prospects only. This policy will not only allow curtailment of expenses, but concentrate efforts and shift the point of view to more urgent matters. I am in favor of complying with clearing house interest requirements, but question the advisability of joining the clearing house . . . In regard to driving small, active accounts out of the bank because they are unprofitable, a word of caution is required. First, some of these accounts may become valuable; and second, are not many of them unprofitable because of the bank's own system and methods of handling them? There is distinct danger in going too far in this direction! The same applies to the question of service charges. Everything considered, the chances of higher net interest on deposits resulting from changed policies are quite good. However, the management must be careful not to adopt policies which will so reduce total deposits that the net effect is unfavorable.

Loans.—Here lies the most "dynamite" and the need for greatest caution. One should be much stricter about making loans in times of prosperity than in times of depression. Since Charles adopted a very liberal loan policy when business was booming, it is feared that the percentage of slow and bad loans really was substantial. The reduction in sizes of loans, the appointment of a new credit manager and a discount committee seem to be steps in the right direction. However, care must be taken about increasing rates on good loans because (1) a rise may lead to the loss of good customers, and (2) depressed times naturally lead to lower rates. Furthermore, to restrict loans to the highest grade borrowers at all times may be bad from the standpoint of earnings. It is wise to take loans which are good risks, but actually appear to be poor, and collect an extra 1% on them.

Investments.—Bankers generally are "terrible" on the question of investments and I fear that Bankshares was on the wrong track in the latter part of 1930. The management was shifting apparently to poorer grade, long-term bonds when (1) the outlook for this type of securities was none too good . . . and (2) liquidity was desirable. The investment policy of Bankshares seems to have been primarily dictated by the question of "return," apparently with fair safety. I doubt whether the Bankshares investment policy did Charles much good. What type of bonds and what kind and size of secondary reserve a bank should have depends entirely on the future outlook. Past performance is only an indication of the *future.* It would be wise for a banker to scrap tradition and work on a more scientific basis.

Personnel.—Indications are that Charles was overstaffed, but it must be borne in mind that reductions in personnel effected by Bankshares were not as important as they appear. Some functions are taken over by Bankshares staff and Charles will probably have to pay out some "nice fat fees." This is one of the curses of the holding company system. The policy of assignment of definite responsibility is excellent. On the question of salaries, Bankshares must be careful not to cut to the point that goodwill will be lost and employees will become resentful. Reduction of staff in the new business department is probably wise.

Results Obtained.—It is impossible to make a fair estimate of the results by the middle of 1931. Not only is the period too short to be representative of anything, but it usually takes much more time than anticipated before the benefits of changes of this nature can be noted. Furthermore, the showing for the first six months of 1931 was favorably affected by the liberal write-off of December, 1930. Finally, there is no telling what the results would have been under the old arrangement, nor to what extent the showing has been affected by the adverse business conditions prevalent at the time.

Certainly, Bankshares appears to have been well protected against bad loans by the trust arrangement, judging from the showing made during the first six months of 1931.[1]

II

I. *Introduction*

The problem *as of July, 1931*, was obviously *not* whether the Charles National Bank should have become a member of the Young group, and, if so, upon what exchange basis. However pertinent these questions may have been in January, 1931, the problem in July was *what policies of bank management should the corporation revise, initiate, or continue in order that the most might be realized from its investment in the new unit.* Having obtained this promising unit on a highly favorable basis of exchange, it was "up to" the group management to make the most of its opportunities.

This paper attempts to review, in order of importance, the various functional and operating aspects of bank management which were or should have been studied when the purchase was effected, and *to evaluate and recommend* courses of action.

II. *Functional*

Reserves.—Since interest on loans and investments is the *major source of income*, and since primary and secondary reserves are necessary bank "inventory *costs*" which directly reduce this income as their size increases, it seems that first consideration should have been given to the fact that the bank had been and was still maintaining excessive liquidity. Primary and secondary reserves amounted to 40.0% of total deposits on June 30, 1930, and were still 32.4% of total deposits on June 30, 1931; including the discountable proportion (say 50%) of loans and discounts, this figure would approach 70% liquidity!

Obviously, then, the new management should study the past movements of loans and deposits, and forecast the probable future hourly, daily, weekly, and monthly reserve requirements, and keep the primary and secondary reserves down to these limits.

Loans and Discounts.—The Young management seems to have lost sight of the fact that the Charles bank has pushed itself along in an apparently highly competitive locality by following a more liberal,

[1] By V. J. Decorte, M.B.A., 1934.

broader loaning policy than that of the other banks. In fact, it seems to have obtained some of the large choice accounts in the locality, and to have extended these accounts lines of credit as large as were needed. The Young management has changed this, reducing lines of credit and making smaller loan renewals, probably wrecking the previous results of hard work and expense on the part of the new business department.

Hence, it seems that the Young management should keep in mind that commercial loans and discounts are the very essence and basis of commercial banking and that the bank has to continue meeting a fairly strong competitive condition. The loss of 13% in loans and discounts between June, 1930, and June, 1931, can be attributed largely to the unintelligent and conventional policy toward the loans and discounts. Moreover, the recommendation that reserves be cut down to the required minimum implies that additional loans, or investments, will have to be sought. With proper evaluation of risk, and with interest and balances to produce income greater than this risk, no loan should be refused as long as funds are available for lending; this bank certainly had the funds.

Investments.—Only after all possible and profitable local commercial loans have been cared for, and minimum primary and secondary reserves have been provided for on the basis of the nature of the deposits and loans, is a bank justified in turning into investments a portion of its assets. The old management did not go heavily into Other Bonds and Securities, luckily enough, though it had experienced a 17% shrinkage in the small amount it did own. The new management has apparently gone into Other Bonds and Securities—probably loading the bank up with some choice Bolivian and Polish debentures—having nearly doubled this account in six months. That is, then, the Young management has increased investments at the expense of loans and discounts. The reverse of this policy is recommended; a bank should prefer local, known risks to more distant, unintelligible "gambles," dependent upon the vicissitudes of the securities market for liquidity and/or yield. The former is banking; the latter tends toward a pawn shop, or, at best, toward an investment trust.

Deposits.—The tightening up on credit policies lessened the demand deposits 7% below their former figure. The reduction in interest rates paid, the enforcement of service charges, and the reduction of the new business department combined to reduce both demand and time deposits, the latter by nearly 20% between December, 1930, and June, 1931. That is, as in the case of the loans and discounts, the new management seems to have gone blindly in, and arbitrarily set up "standards" which the competitive position of the bank did not warrant and could not stand. The new management, then, seems to have taken the path of least resistance—attending first to such details as account analysis, service charges, and interest paid on deposits, and reducing the bank's competitive strength, rather than giving prime consideration to "reserve expenses," loans, discounts, and investment policies, the proper handling of which might well permit the continuance of services which had built up the bank in the past.

The new management should use its cost system to show it where its methods are faulty, what the most profitable kind of new business to go out for is, and what size the new business department should be. No blanket indictment should have been rendered against the small deposits *per se*, or against the new business department; both are requisite to a growing bank with larger competitors. The reasoning to be followed concerning old deposits is as follows: what is it worth, what does it cost, and why? In regard to new deposits: what will they be worth, and how does this compare with the alternate possible costs of obtaining them?

III. *Operating*

Personnel.—Having attended to the major preceding functional policies, the Young management should then have turned to the operating policies. Wholesale reduction of salaries, discharging of officers and employees, and exchanging employees with other members of the group does *not* seem an advisable policy, when all is effected in the first six months. Though salaries and wages constitute the second largest item of a bank's expense, a careful job analysis should have been made to determine when, how many, and what men were needed. Moreover, the drastic salary reduction would not produce the cooperation and patience that is at a premium when moves of this sort are being made. It will be noticed that salaries were reduced only 15% during the *second* quarter of 1931, and that "other expenses" increased nearly 11%. In fact, the major reductions (20%) were made in interest paid on deposits, the easiest but most doubtful "saving" that could have been made. It seems that if the Young group intends to develop the potentialities of the Charles bank, that is, improve the quality of the bank management displayed, it is pursuing a mistaken policy in reducing the compensations of an already notoriously underpaid profession.

Departments.—The existence of some of the bank's departments might be questioned, and subsequently contracted, continued, or enlarged. Since this is a group system, each bank will have to remain fairly self-sufficient, but there may be some departments whose loss from carrying exceeds the probable loss from dropping. A job and cost analysis by departments should be made, keeping in mind the place in the community which the bank is attempting to obtain.

IV. *Conclusion*

The Young Bankshares Corporation has made *no* major moves to realize upon the bargain it obtained in its purchase of the Charles National Bank; on the contrary, it has initiated policies which threaten to *undermine* the earning power of the bank. The problem of bank management which faces the corporation seems to resolve itself into one of the following:

A. *Proper determination of functional policies*

1. Reserves no larger than necessary to meet legal and operating requirements.

2. Aggressive pursuit of profitable commercial loans.
3. Investments relegated to minor position, secondary to the above two.
4. Intelligent "cost-value" attitude toward deposits, with minimum attention to the "NRA attitude" toward service charges, balances, etc.

B. *Proper determination of operating policies*
1. The "job" approach to determination of number and compensation of personnel.
2. Review of need for, cost of, and income from *existing* or *additional* departments.

It seems to follow, then, that in order to reverse the continued down trend in the bank's operating statistics, the corporation must effect a right-about in its policies of bank management, giving less attention to relatively minor items of expense, especially when the reduction of some of these, such as interest paid on deposits, salaries, etc., may not necessarily be desirable, and devoting more time to questions of (1) reserves, (2) loans and investments, and (3) deposits. These are items that not only play the major part in determining profits, but also indicate the competitive position the bank will be able to maintain in the community. It is, briefly, a question of the holding company's failure to exercise to the fullest extent functions that are implied in the term "bank management."[1]

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[1] By R. L. Johnson, M.B.A., 1934.

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